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FEDERAL-STATE COOPERATION IN THE ADMINISTRATION OF THE INCOME TAX —THE WISCONSIN EXPERIENCE †

NORMAN ADLER *

I. *Introduction*

INTEREST in federal-state cooperation in the administration of the income tax arose shortly after the federal income tax of 1913 was enacted. This was a perfectly natural development once both levels of government made use of the income tax. The overlapping of tax administrations offers the opportunity for the two taxing authorities to reenforce each other in reducing noncompliance to a minimum by: (1) making information obtained by one administration readily accessible to the other; (2) having the experience of one provide guidance for the other; and (3) having the two parties complement each other by specialization in certain areas, such as the coordination of auditing activity.

The most striking characteristic of the entire development of federal-state cooperation up to 1950 was its one-sided nature; virtually all of the traffic being in the direction of the states. The states were able to obtain from the Internal Revenue Service: (1) lists of all individuals filing federal returns; (2) copies of all individual returns; (3) copies of federal audits of such returns; and (4) lists of employers withholding federal taxes. Since the Service was not getting much return from the states by way of helping it to expand its own audit coverage, it finally decided to attempt to remedy the situation, and asked certain states if they would exchange audit information with it on a test basis.

Thus in the early part of 1950 the federal government entered into separate agreements with North Carolina and Wisconsin providing for the automatic exchange of audit information. This program, known as the federal audit-exchange (or cooperative audit) program, grew out of a conference on intergovernmental tax problems and fiscal relations at the Treasury in 1949,

† The material contained in this article is based on work done for a doctoral dissertation at the University of Wisconsin under the supervision of Professor Harold M. Groves. The author is greatly indebted to Professor Groves for his guidance and would also like to express his appreciation for the assistance rendered to him by Harry W. Harder, Wisconsin Commissioner of Taxation, and for the complete cooperation of the members of the Wisconsin Department of Taxation. Dr. Joseph A. Pechman reviewed an earlier draft of this paper and made a number of helpful and critical comments. The views expressed herein are the author's own, and do not necessarily reflect those of these individuals.

* The author is an economist in the National Income Division, Office of Business Economics, U. S. Department of Commerce, Washington, D. C.

and was essentially an experiment to determine the feasibility of an exchange of audit information under which the duplication of auditing by the federal and state tax administrations would be reduced to a minimum. At a conference held between the participants in the program in December, 1950, there was general satisfaction with the way the program was progressing. During the succeeding two years, three more states entered into cooperative agreements with the federal government—Kentucky and Montana in 1951, and Colorado in 1952. Until 1957, the audit-exchange program continued unchanged as a test operation.

From the revenue standpoint, the program has been successful so far as the five state governments are concerned. Although the program has been somewhat of a disappointment in so far as federal revenues are concerned, except for the results in Wisconsin, an exact *quid pro quo* between the two levels of government, given the large comparative advantage of the federal, is not to be expected. Since the initial attempt by the federal government to turn federal-state cooperation into a truly reciprocal relationship succeeded only in Wisconsin, the experience in that state will be of interest both to tax administrators and other experts in taxation. This paper summarizes and evaluates the Wisconsin program on the basis of a first hand investigation made by the author in 1957-1958.[1]

II. *The Wisconsin Experience Under the Federal Audit-Exchange Program*

In January, 1950, Wisconsin entered into a cooperative agreement with the Internal Revenue Service to exchange information on income-tax adjustments. This agreement had been sought by the State Tax Commissioner for many years and had also been pushed by the Governor of Wisconsin at the United States Governors' conferences. Wisconsin was chosen for a trial operation of the exchange program because it not only had the oldest state income-tax law in the nation, but it was one of the few states where administration had reached a level of competence that afforded mutual incentive for this type of cooperation. In the opinion of the State Tax Commissioner, "under the plan, Wisconsin tax returns probably would receive more thorough auditing than those of any other state."[2] He estimated that "the Bureau of Internal Revenue probably makes four to six times as many field examinations in Wisconsin than does the state."[3]

Wisconsin tax officials expected the state to profit considerably from the agreement. In view of the state's high level of administration, it was felt that the federal government would also reap substantial benefits from the arrangement. It is thus apparent that this initial test of the cooperative audit program in Wisconsin was initiated under the most favorable of conditions.

Six months after the program was put into operation, the Tax Commissioner reported that Wisconsin's partnership with the federal government in the apprehension of income-tax evaders and the examination of income-tax returns of Wisconsin residents was working "very satisfactorily." A year later, in

[1] The complete results of this study are found in the author's doctoral dissertation: *The Administration of the Individual Income Tax with Respect to the Receipt of Wages and Salaries, Interest, and Dividends*, University of Wisconsin, Madison, 1958, Chapter X.

[2] *Wisconsin State Journal*, January 19, 1950, p. 1.

[3] *Loc. cit.*

1951, the Director of the Income Tax Division, in summing up Wisconsin's experience, stated:

> We are sold on it. . . . During the time that it has operated the Federal Government has furnished about 27,000 transcripts of adjustments from which we made assessments totaling almost a million dollars. . . . Of these 27,000 cases . . . , probably only about 2,000 were corporations; the rest were all individuals' transcripts. When we know of the audits made by the Federal Government, we don't have to go in and audit those person's books; when we send a copy of one of our audits to the Federal Government, maybe the Federal Government won't have to make an audit. We don't actually make the audit for the other party, but we exchange information that the other party can use in lieu of an audit.[4]

Concerning the reciprocal nature of the program, he said:

> The exchange program between the Federal Government and the State of Wisconsin is not an entirely one way street. During the time that it has operated, . . . we furnished the Federal Government about 39,000 transcripts. I don't know, of course, how much good the transcripts we furnished were to the Federal Government. Probably many of our transcripts couldn't be used; we didn't use a lot that the Federal Government gave us because they were not applicable. But I just wanted it to be known that we probably do as much work for the Federal Government as they do for us in this exchange program.[5]

It is apparent from the data presented in Table I that the volume of transcripts exchanged under the program has been very substantial.[6] During the period May 1, 1950, to June 30, 1958, Wisconsin sent 129,576 audit-report abstracts covering 236,845 income years to the Internal Revenue Service; of these, 122,489 were the result of office audits and 7,087 resulted from field audits. In return Wisconsin received 99,047 transcripts from the Internal Revenue Service. (No data are available showing the breakdown between office and field audits.) Though Wisconsin has rather consistently provided more abstracts than it receives, a greater proportion of the federal transcripts represent field audits carrying more detail and larger items. For example, in calendar year 1957 the Internal Revenue Service sent approximately 6,550 abstracts to Wisconsin, of which about two-thirds, or 4,400, were the result of field audits.[7] On the other hand, in fiscal 1957 Wisconsin sent 13,171 transcripts covering 25,944 income years, of which 929, or 8 per cent, covering 3,384 income years were the result of field examinations. The Service has been conducting approximately eight times as many field audits in the state as has the Wisconsin Tax Department. Though this comparison is subject to many qualifications —differences in defining what constitutes a field audit, the number of income years covered in each audit, the thoroughness of the audit, and so forth—it does indicate that the Service is making

[4] *Proceedings of the National Tax Association Conference* (1951), p. 105. It was estimated that 15,000 of the 27,000 abstracts received from the Internal Revenue Service were used.

[5] *Loc. cit.*

[6] The decrease in fiscal 1952 in the number of transcripts exchanged was due to an agreed change in procedure, under which audit adjustments of various types having no value to the other governmental agency were to be screened out. The screening mainly affected office-audit assessments; in the case of field-audit assessments very few, if any, of the transcripts were to be screened out because of the variety of adjustments usually contained therein.

[7] Interview with E. G. Schmidt, Assistant Chief of the Audit Division, Office of the District Director of Internal Revenue, Milwaukee, April 16, 1958.

TABLE I

RESULTS OF THE AUDIT EXCHANGE PROGRAM WITH THE FEDERAL GOVERNMENT IN WISCONSIN, FOR THE PERIOD MAY 1, 1950 TO JUNE 30, 1958

Fiscal year	Transcripts provided		Transcripts received	Amount of additional assessments entered on tax roll
	Taxpayers	Income years		
		Individual		
1949–50 (May-June)	6,282	8,822	3,940	$ 28,100
1950–51	31,125	42,704	21,174	599,956
1951–52	11,265	22,039	15,319	574,118
1952–53	13,683	26,946	14,370	523,046
1953–54	13,283	28,126	7,799	346,230
1954–55	13,357	26,878	9,413	541,285
1955–56	13,842	26,865	7,171	290,033
1956–57	12,925	25,070	5,762	349,671
1957–58	11,574	22,724	5,605	327,016
Total	127,336	230,174	90,553	$3,579,455
		Corporate		
1949–50 (May-June)	116	355	565	$ 3,138
1950–51	462	1,109	1,625	74,560
1951–52	209	652	951	101,405
1952–53	269	804	666	74,728
1953–54	131	285	398	39,792
1954–55	315	951	859	83,948
1955–56	254	761	830	104,570
1956–57	246	874	1,550	134,856
1957–58	238	880	1,050	207,537
Total	2,240	6,671	8,494	$824,534
		Total		
1949–50 (May-June)	6,398	9,177	4,505	$ 31,238
1950–51	31,587	43,813	22,799	674,516
1951–52	11,474	22,691	16,270	675,523
1952–53	13,952	27,750	15,036	597,774
1953–54	13,414	28,411	8,197	386,022
1954–55	13,672	27,829	10,272	625,233
1955–56	14,096	27,626	8,001	394,603
1956–57	13,171	25,944	7,312	484,527
1957–58	11,812	23,604	6,655	534,553
Total	129,576	236,845	99,047	$4,403,989

Source: Compiled from statistics made available by the Wisconsin Department of Taxation.

substantially more field audits in Wisconsin than is the state.

Of the total abstracts received by the state, about 55 per cent contained information which was used to make additional assessments. A little over half of the abstracts which could not be used contained adjustments which were not applicable, while almost 30 per cent involved adjustments which had previously been made by state auditors. This category includes adjustments which were voluntarily disclosed by taxpayers whose federal returns had been adjusted. Since it is very likely that most of these disclosures were made because the taxpayers knew that the state would be notified automatically of the adjustments made to their federal tax returns, these adjustments should be credited to

the abstract program. However, these cases constitute a negligible part (2 per cent) of the total abstracts received. About 11 per cent of the abstracts contained adjustments which were too small to bother with. Only slightly more than 5 per cent of these abstracts could not be used because the case had either previously been field audited or the four-year statute of limitations had run out.

Although a considerable number of abstracts could not be used, those that were used produced very substantial benefits at a very small cost to the state. During the period May 1, 1950 to June 30, 1958, the state assessed $4.4 million in additional taxes based upon information contained in federal abstracts.[8] This compares with total additional collections during the period of $35.2 million. Thus about 12 per cent of the additional collections made during this period are directly attributable to audit information received from the Internal Revenue Service.

Though the Internal Revenue Service maintains statistics covering the operation of the program, this information has not been made public for recent years. Data for fiscal 1955 indicated that a fair balance of trade between Wisconsin and the federal government existed at that time,[9] and it is known that the same favorable relationship has been maintained since then.[10]

III. *A Case Study of Wisconsin's Use of Federal Abstracts*

For the purposes of this study a " batch " of abstracts was chosen which had been received by the Madison district office in March, 1956.[11] The summary sheets made up for each batch of abstracts received were examined and a random selection was made from those indicating that the abstracts had been completely processed, the taxpayers owing additional taxes assessed, and almost all of the tax had been collected.[12]

Of the 146 abstracts covered by the summary sheet chosen, three had been sent to another district office and two could not be found, leaving a working sample of 141 abstracts. Of these, 71 abstracts, applying to 56 individual taxpayers, contained information which

[8] This total is comprised of $3.6 million assessed against 35,254 individuals, and $0.8 million assessed against 2,157 corporations. Almost two-thirds, or $2.9 million, of the total additional assessments was picked up through office audits, with the remaining $1.5 million being realized through field audits.

[9] For the fiscal year 1955 the Internal Revenue Service levied a total of $0.8 million of additional assessments attributable to items in Wisconsin abstracts (Harold M. Groves, " Income-Tax Administration," *National Tax Journal*, Vol. XII, March 1959, p. 51). In the same year Wisconsin made additional assessments of $0.6 million based upon information contained in federal abstracts.

[10] See below, pp. 198 and 199.

[11] The abstracts are received in the corporation-division office where, after dividing them into corporate and individual cases, the latter are sorted by tax districts (the individual-income tax is administered from four district offices) and then forwarded to the proper district office.

[12] Upon receipt in the Madison district office, the abstracts are alphabetized by taxpayer's name, and the returns of these taxpayers are secured from the tax files and compared against the abstracts to see what type of action is called for. Two categories of abstracts are immediately set aside: (1) abstracts involving cases previously adjusted—both voluntary disclosures by the taxpayer, and state-initiated cases; (2) abstracts which cannot or will not be used either because the return is closed to adjustment by the statute of limitations or by having been field audited, the adjustment is not applicable or is too small, or the return cannot be found. In the remaining cases the tax returns are office audited and assessments are made. Federal audit reports are requested from the taxpayer where the assessment cannot be made on the basis of the information contained in the abstract itself. If the taxpayer does not reply within 15 days, the assessment may be made solely on the basis of the information in the abstract. Adjustments too complicated to handle by the office auditor are referred to the field-audit staff.

was used to assess additional taxes. Of the abstracts not usable, 35 abstracts, involving 12 taxpayers, contained adjustments which had previously been assessed. Two of these abstracts concerned taxpayers who had voluntarily disclosed the additional federal assessments; the other 33 abstracts covered assessments resulting from action initiated by the state, and 17 of these cases were the result of field audits. The remaining abstracts included 31 with adjustments which were not applicable, one where the adjustment was too small, and three which could not be used due to expiration of the four-year statute of limitations.

Table II presents the results obtained

TABLE II

Adjustments Made To Wisconsin Tax Returns Compared With Those Reported On Federal Abstracts

	Net additional income	Net unallowable deductions	Total net adjustment
Federal abstract .	$104,544	$109,409	$213,953
State tax return			
Total	26,104	77,900	104,004
Only years on federal abstract ...	14,081	61,773	75,854
Ratio of amount reported on federal abstracts to amount picked up on state tax returns			
Total	25.0%	71.2%	48.6%
Only years on federal abstract ...	10.9	56.5	35.5

Source: Sample group of 71 federal abstracts used by the State Tax Department to assess additional taxes.

from comparing the adjustments reported on federal abstracts against those made by the state audit staff for the 71 abstracts used by it to levy additional assessments.[13] A total of $213,953 was reported on the federal abstracts and $104,004 was picked up on the state tax returns,[14] which is 49 per cent of the total reported on the abstracts. Of the $104,004 picked up on state tax returns, $28,150, or 27 per cent, came from tax returns for years other than the particular year on the federal abstract. Taking only the adjustments made on returns for which federal abstracts were received, $75,854 was picked up; this is 36 per cent of the total reported on the federal abstracts. However, since in almost all cases where errors were found for other years these errors would not have otherwise been discovered, it is proper to credit the entire amount to the leads furnished by the federal abstracts.

IV. *Evaluation of the Audit-Exchange Program in Wisconsin*

The success of the audit-exchange program in Wisconsin is unquestioned. Both federal and state tax officials are highly enthusiastic about it.

In the opinion of Wisconsin's Tax Commissioner:

> This free interchange of adjustments between the federal government and the state is one that all states with an income tax law should investigate. It is one way of making use of the audit staff of the Internal Revenue Service. While the program has been very productive from Wis-

[13] The adjustments made to the tax returns were divided into the following categories: unallowable deductions, additions to income, nontaxable income, and additional deductions. The latter two categories contained very few items and were therefore deducted from the first two categories in obtaining our final figures.

[14] Business profits, farm income, wages and salaries, dividends, and capital gains accounted for 94 per cent of the net additional positive income of $26,104. The most important of the unallowable deductions were: business expenses, traveling expenses, auto expenses, contributions, entertainment, and depreciation, which together accounted for 92 per cent of the total of $77,900.

consin's standpoint, undoubtedly information furnished by the state has been very remunerative to the Service, and the Service probably gains more in Wisconsin than in any other state.[15]

Federal officials in Wisconsin have been well pleased with the program, and they have acknowledged the fact that it has been a " two-way street." [16]

While the audit-exchange program has made available a great wealth of information, the reported error is not fully convertible into additional assessments by the recipient. In our sample study it was found that only about 36 per cent of the error reported on the federal abstracts used by the state could be converted into additional assessments. This is due to many causes, the most obvious of which is the difference in the revenue laws of each agency. Also, since the Wisconsin tax statutes require that all returns be audited, some of this error had already been picked up by the state prior to its receipt of the federal abstracts. Moreover, it is not possible for the Service to screen out all of the adjustment items in which the state would have no further interest, and consequently it is simpler for the Service to furnish certain information, leaving it to the State Tax Department to weed out the unusable information.

Although a considerable amount of the federal discovery cannot be used by the state, the program involves very little processing and additional assessments can be made at a negligible expense. The ratio of taxes collected to time spent is extremely high. For example, while the office auditor in charge of the program in the Madison district office spends about one-quarter of his time on this work, he estimates that about one-half of the additional collections he makes during a normal year result from leads furnished by the federal abstracts. From the standpoint of additional taxes collected he feels that this is the most productive work in the entire office.[17]

Despite the excellent results achieved by the program, it has thus far operated strictly as an exchange of audit reports. There has been no real cooperation in the tracking down of tax evaders, with each side taking the initiative where it is best able to and being backed up by the other. The State Tax Department has been unable to get the worksheets on individuals currently being investigated by the Internal Revenue Service and has had to wait until an abstract of the assessment levied against the individual is made available. In many cases, especially those involving fraud, the most important information is contained in the work papers, and these have not been open to inspection by state auditors. The result has been that the state has had to make its own independent investigation spending the time of its auditors duplicating what the federal auditors have already done.

Since the information given in the abstracts is very often inadequate for assessment purposes, it is necessary to ask the taxpayer for a copy of the federal audit report,[18] or in the absence of

[15] Personal interview with Harry W. Harder, Wisconsin Commissioner of Taxation, Madison, March 17, 1958.

[16] Personal interview with Walter Stumpf, Assistant District Director (Milwaukee), Internal Revenue Service, April 16, 1958.

[17] Personal interview with Walter Streich, office auditor, Madison district office, Wisconsin Department of Taxation, April 10, 1958.

[18] Although Wisconsin has no specific statute requiring taxpayers to submit federal audit reports, the general statutes with respect to disclosure of information by taxpayers are sufficient to support this action.

this to levy arbitrarily "in the dark." This practice varies among the district offices. For example, in the Madison district office about 65 per cent of all federal abstracts require a letter to the taxpayer requesting a copy of the federal audit report; [19] however, in the Milwaukee district office (which is the largest in the state) only 25 per cent require a copy of the federal audit report.[20]

It is thus apparent that while the audit-exchange program in Wisconsin provided substantial benefits to both parties during its eight years of operation, it did not go far enough. Its provisions were not broad enough to permit the exchange of sufficient information and it made no provision for any coordination of the auditing activities of the two administrations.

V. *Recent Efforts to Improve the Program in Wisconsin*

It was not until November, 1957, that a conference was held between officials of the Wisconsin Department of Taxation and the Internal Revenue Service to consider the revision of the audit-exchange program. The aim of the new agreement reached at this conference and approved by the Commissioner of Internal Revenue in May, 1958, is to eliminate duplication of audits and generally to secure full cooperation between the parties. Broad power is given to the District Director in Milwaukee to make the necessary arrangements with the Wisconsin Tax Commissioner to bring about the desired objectives.

The agreement provides for the following:

1. In non-fraud cases, in addition to the exchange of abstracts, explanations of adjustments and the supporting material will be made available at the request of either party.
2. In fraud cases no information will be exchanged where criminal prosecution is involved. In civil fraud cases (including those where the criminal fraud aspects have been disposed of) somewhat less information than that provided in non-fraud cases will be exchanged. However, this will still be considerably more than was provided under the old agreement. (In those cases in which the 50 per cent fraud penalty was involved, only the upper portion of the abstract showing the adjusted taxable income and the tax deficiency had been filled in.)
3. Procedures are being worked out under which the Internal Revenue Service will provide the Wisconsin Tax Department with the names of taxpayers whose returns have been selected for examination, but which have not been reached at the end of its regular audit cycle.
4. Arrangements are being made for information returns received in the District Director's office in Milwaukee to be made available to the state after the Service has completed its operation.[21]
5. Wisconsin will provide the Internal Revenue Service with copies of its refund rolls.
6. Whenever either party inaugurates a special canvassing or other program aimed at detecting non-filers in an area in which both parties are interested, the other party is to be notified so as to avoid duplication of effort.

[19] Interview with Streich, *op. cit.*

[20] Letter from W. Merrill Sawyer, Assessor of Incomes, Milwaukee district office, Wisconsin Department of Taxation, April 11, 1958.

[21] Wisconsin's Tax Commissioner has requested that the Internal Revenue Service turn over all unused information returns. However, since only returns for certain letters of the alphabet are receivd by the District Director in Milwaukee each year, only those information returns in this group which have not been used can be made available to the state.

7. Information will also be exchanged on gift and estate and motor-vehicle-fuel taxes.

VI. *The Outlook for the Future Development of the Audit-Exchange Program*

The results obtained during the testing phase of the program (1950-1956) showed that substantial benefits in the form of additional taxes had been realized by the participating states. However, from the standpoint of the Internal Revenue Service with the exception of Wisconsin the exchange of audit information left much to be desired, both quantitatively and qualitatively and consequently did not yield much additional federal tax. The original agreements also were not readily adjustable to take advantage of special circumstances or opportunities existing in particular states.

Developments at both the federal and state levels influenced the Service in 1956 to consider anew the current status and future course of the audit-exchange program. The report of the President's Commission on Intergovernmental Relations of June, 1955, although concerned mainly with broad principles, gave strong support to tax-coordination activities. The Commission recommended the appointment of a Presidential staff assistant on intergovernmental activities, mentioning improved tax coordination as one of the activities for which it would be an effective vehicle. This recommendation was carried out. In August, 1956, the Governor of Minnesota wrote to the President pursuant to the Commission's report, and the White House urged the Internal Revenue Service to allow Minnesota to participate in the audit-exchange program.

According to the Deputy Commissioner of Internal Revenue: "These events came about coincident with our own decision that the time was ripe for the Service to resurvey the audit exchange program and make plans for shaping its future development." [22] The following three objectives have been established as the guiding principles for the future development of the program:

1. To tailor each new agreement to the administrative situation prevailing in the particular state. Factors to be considered are the laws of the state, the pattern of its tax system, and the scope and strength of its enforcement activities, and the possibilities for effective coordination of federal and state audit activities.
2. To maximize the total benefits from the program. This would involve the broadening of the scope of information exchanged beyond the income-tax return to include excise, estate, and gift taxes. Other areas that would be considered include the division of territory for concentration of audit work, and cooperative efforts in canvassing for non-filers.
3. To obtain a better balance between the benefits received and the costs incurred by the Internal Revenue Service. In deciding what part of its annual budget can be justified as a contribution to the audit-exchange program, each district office participating in the program must consider both the volume of benefits accruing to the state and those to the Service. While it is not the intention of the Internal Revenue Service to insist upon an exact *quid pro quo,* nevertheless, larger benefits received from the program represent justification for incurring heavier expenses in support of

[22] O. Gordon Delk, Jr., "Federal-State Exchange of Information," speech at the Annual Conference of the National Association of Tax Administrators (June, 1958).

it. (The Service has offered to furnish assistance to any state attempting to improve its audit and enforcement activities.)

These three objectives served as the basis for the drafting of the agreement with Minnesota in May, 1957, which constituted the first of the "new order" of federal-state cooperative enforcement-activity programs. This agreement goes beyond the five original pacts in that it provides for mutual planning of audit programs, thereby enabling federal investigators to work with the state tax officials in area and joint compliance drives.

The present plans of the Internal Revenue Service call for the incorporation of these principles into every agreement set up under the program. Wisconsin was chosen as the place to initiate the "second time around" negotiations with the original participants in the program. As soon as is practicable the Service intends to reappraise the other agreements now in force with a view towards increasing the mutual benefits realized from them. In addition, it stands ready to receive inquiries from any state if its tax officials really believe that the state is so situated and equipped that it can become "a full partner in a joint program."

The further extension of the program both to other states [23] and its intensification in the states already covered thus depends to a large extent on what state tax administrators are able to do in the development of their own enforcement programs. In the opinion of the Deputy Commissioner of Internal Revenue "significant progress has already been made, and . . . there is a high potential for further advances within the foreseeable future." [24]

VII. *Conclusion*

Federal-state cooperation in income-tax administration offers many opportunities for fruitful cooperation between the two parties. Although much progress has recently been achieved, many unutilized potentialities still exist.

The income-tax states vary greatly in the caliber of their enforcement programs and the resources at their disposal. A great many of the states have weak tax administrations and are thus not in a position to provide genuine reciprocity for federal assistance, although one should certainly not expect the states to provide an exact *quid pro quo*. Also, the information the states can give is potentially more valuable than its counterpart, item for item, because of the substantially higher federal rates. Moreover, the federal government is in a position to give these states an incentive to improve the quality of their enforcement activities, and the Internal Revenue Service has recently indicated its willingness to cooperate in assisting state tax administrations on a variety of projects.

Turning to the better state tax administrations, some of them are doing work which compares favorably with the federal performance. This affords the opportunity for bilateral cooperation. The audit-exchange program represents the most notable achievement in the

[23] A number of these states do exchange audit information with the Internal Revenue Service on an automatic basis. In these states the arrangements have been made with the District Director of Internal Revenue on an informal basis. Only the states mentioned in this article have formal agreements with the Commissioner of Internal Revenue which outline the scope of the program and the procedures to be followed. A complete description of the use made of federal information by each state can be found in Chapter IX of the author's doctoral dissertation, *op. cit.*

[24] Delk, *op. cit.*

area of mutual cooperation between the federal and state tax administrations. However, with the exception of Wisconsin the federal government has derived very little benefit from the enforcement activities of the participating states; and even in Wisconsin the program was limited to the exchange of audit information.

The new approach recently adopted by the Internal Revenue Service has already produced important results. The Minnesota agreement which was the first result of the Service's new approach represents a significant step forward toward the ultimate goal of having the federal and state administrations coordinate their enforcement activities, and comes closer to the ideal of coordinated auditing than anything previously tried. The new agreement with Wisconsin represents another advance in this direction. It establishes a broad basis for administrative coordination between the Service and Wisconsin tax officials, and marks a basic expansion in the concept of exchange of information by providing for the use of other sources of information and for joint activities where they would appear advantageous to the participants.

Thus at the present time it is evident that we are moving in the direction of greater cooperation between the federal and state tax administrations. In a state such as Wisconsin where tax enforcement is on a par with that of the federal government both parties are currently attempting to enlarge the area of cooperation between them. Further advance depends upon the working out of mutually acceptable terms for putting the expanded program into effect, and here the recent results have been very encouraging. In Minnesota, there has been general satisfaction with the nature of the agreement, but it is still too early to evaluate the ultimate results of the program.

The extent to which other states will be able to participate in this program depends primarily upon the efforts made by these states to improve their enforcement programs to the point where they can provide sufficient incentive for the Internal Revenue Service to enter into joint arrangements with them. Several of these states have expressed an interest in entering the program, and at the present time it is reasonable to expect that at least some of them will eventually be included in the Service's cooperative enforcement-activity program.

After 45 years of duplicate income-tax administration progress in the direction of coordinated enforcement activity between federal and state administrations certainly has been long overdue. However, the recent revival of interest together with some concrete accomplishment in this area provide promise of substantial progress within the foreseeable future. A development of this nature would do much to strengthen tax enforcement throughout the entire country, and would be especially welcome at a time when all levels of government are seeking ways to increase their revenues.

THE PRIORITIES OF FEDERAL TAXES OVER STATE AND LOCAL TAXES†

WILLIAM T. PLUMB, JR.*

EVERY tax administrator is familiar with tax liens and priorities statutes, which are potent weapons for the collection of taxes at all levels of government. The federal tax collector, however, has an efficient armory of liens and priorities which his opposite numbers at the state and local level may well envy.[1]

I. PRESENT STATUS OF TAX LIENS

The General Federal Tax Lien

Most important is the general federal tax lien, which attaches to "all property and rights to property, whether real or personal, belonging to" the taxpayer,[2] including any property which he may acquire in later years, until the statute of limitations bars the tax.[3] Although it is the most "general" of liens, it is not considered "inchoate,"[4] but has been described as an ownership interest in the taxpayer's property.[5] The lien becomes fully effective when the tax is assessed, without need for perfecting it by enforcement action or even for giving public notice of any kind—except that, as against mortgagees, pledgees, purchasers and judgment creditors, the lien becomes valid only when notice of it is filed.[6]

Although the lien statute does not purport to confer a priority, and the Supreme Court itself has said that the controlling principle is "first in time is first in right,"[7] in practice the federal lien now enjoys something approaching absolute priority. For the Supreme Court has declared that, in order to rank as "first in time," the competing non-federal lien must be a "choate" one, and has laid down a standard of "choateness" so rigid that the real-property-tax lien is the only kind of lien which the Court has ever acknowledged as meeting the test.[8] For example, a mechanic's lien is not deemed "choate" even after the work has been performed, the mechanic's lien filed, and suit timely commenced.[9] A contractual lien to se-

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* The author is partner in the firm of Hogan and Hartson, Washington, D. C., and a member of the Special Committee on Federal Liens of the American Bar Association.

1 A comprehensive 150-page discussion of the subject is found in Plumb, "Federal Tax Collection and Lien Problems," 13 *Tax Law Review*, p. 247 and 459, reprints of which are obtainable for $2.00 from the author, 5214 Kenwood Ave., Chevy Chase 15, Maryland.

2 Internal Revenue Code (hereafter I.R.C.) § 6321.

3 Glass City Bank v. United States, 326 U.S. 265 (1945).

4 United States v. City of New Britain, 347 U.S. 81, 84 (1954).

5 United States v. City of Greenville, 118 F.(2d) 963, 965 (4th Cir. 1941).

6 I.R.C. § 6323.

7 United States v. City of New Britain, 347 U.S. 81 (1954).

8 *Ibid.*

9 United States v. White Bear Brewing Co., 350 U.S. 1010, *rev'g* 227 F.2d 359 (7th Cir. 1955).

cure an indemnity is still deemed inchoate after the risk has been assumed, so long as the loss has not yet occurred.[10] Attorneys' liens,[11] landlords' liens,[12] artisans' liens,[13] statutory vendors' liens,[14] warehousemen's liens,[15] attachment and garnishment liens,[16] and the interest of a contract purchaser [17] all have been held inchoate and inferior to subsequently arising federal tax liens.

The most remarkable thing about the "choateness" test is that it is not applied consistently to the federal tax lien itself.[18] The test, as applied to non-federal liens, requires that the property subject to the lien be specifically identified, and possibly even that the lien must have been enforced to the extent of taking title or possession of the property.[19] Yet the federal lien itself, which attaches to the general mass of the taxpayer's property, without need for seizure or other act, is deemed "choate." [20] The test further requires that the amount of the non-federal claim be fixed beyond possibility of contest, before the non-federal lien can be deemed "choate." And yet the federal tax assessment is deemed a "choate" lien despite the fact that it may in many cases be arbitrary or otherwise excessive and is subject to contest in the Tax Court or by suit for refund.

Special Federal Tax Liens

In the case of estate taxes, gift taxes, and certain alcohol taxes, the general federal tax lien is supplemented by a special lien. The estate-tax lien is on all the property taxable in the gross estate, including property formerly held jointly, property transferred in contemplation of death, and certain other *inter vivos* transfers, in addition to property passing at death.[21] The gift-tax lien attaches to the donated property.[22] Those special liens arise at the moment of death or of the gift, without need for assessment, and long before the tax is even computed on a return. While certain protection is provided for mortgagees, pledgees, and purchasers, all other lienors are subject to the secret lien. And, despite the lack of decided cases on the point, it is probable that non-federal liens existing even before the death or the gift, at least if they fail to meet the rigid "choateness" test, will be subordinated.[23] In the case of distilled-spirits

10 United States v. R. F. Ball Construction Co., 355 U.S. 587 (1958), *rev'g* 239 F.2d 384 (5th Cir. 1956), *which aff'd* 140 F. Supp. 60 (D.C. Tex. 1956).

11 United States v. Goldstein, 256 F.2d 581 (2d Cir. 1958), *aff'g* United States v. Pay-O-Matic Corp., 162 F. Supp. 154 (D.C. N.Y. 1957), *cert. denied*, 358 U.S. 850 (1958). *Cf. contra: In re* Washington Square Slum Clearance, 5 N.Y.2d 300, 157 N.E.2d 587 (1959), *cert. pending*.

12 United States v. Scovil, 348 U.S. 218 (1955).

13 United States v. Toys of the World Club, 170 F. Supp. 450 (D.C. N.Y. 1959).

14 United States v. Morrison, 247 F.2d 285 (5th Cir. 1957).

15 Styles v. Eastern Tractor Co., 154 F. Supp. 393 (D.C. N.Y. 1957).

16 United States v. Acri, 348 U.S. 211 (1955); United States v. Liverpool & London Ins. Co., 348 U.S. 215 (1955).

17 Leipert v. R. C. Williams & Co., 161 F. Supp. 355 (D.C. N.Y. 1957). *Contra:* Niagara County Savings Bank v. Reese, 59-2 U.S.T.C. ¶ 9508 (N.Y. Co. Ct. 1958).

18 See Beeghly v. Wilson, 152 F. Supp. 726, 734 (D.C. Iowa 1957).

19 *Cf.* United States v. Gilbert Associates, 345 U.S. 361 (1953), a case arising under the insolvency priority statute discussed *infra* at note 25. It has been questioned whether the "choateness" test applicable under the *lien* statute requires divestment of title or possession. See *infra* note 39.

20 *Supra* note 4.

21 I.R.C. § 6324(a).

22 I.R.C. § 6324(b).

23 See Michigan v. United States, 317 U.S. 338 (1943), treating the question as an open one.

taxes, the tax is expressly made a "first lien" on the premises, the equipment, and the product.[24]

Insolvency and Bankruptcy Priorities

If an insolvent debtor of the United States goes into receivership or makes an assignment for creditors, or if a decedent's estate is insolvent, the law requires that the federal claims be the first ones satisfied out of the assets under administration.[25] Unsecured creditors and those whose liens are regarded as "inchoate" are subordinated; and the Supreme Court has frequently pointed out that, on its face, the priority is *absolute*, and the Court has declined to say whether even a mortgage or a specific and perfected lien could prevail over the federal priority.[26] The lower courts, however, have protected prior mortgages,[27] judgments,[28] and specific liens for real-property taxes.[29]

Paradoxically, if the insolvent debtor goes into bankruptcy, an entirely different set of rules prevails. Pre-existing liens, with some exceptions, are recognized in bankruptcy.[30] But those tax claims which are not supported by liens valid in bankruptcy are all on a parity, with federal, state and local authorities sharing pro rata, ahead of most unsecured creditors.[31]

State and Local Tax Liens

Except to some extent in bankruptcy, therefore, the state or local tax collector has found himself hopelessly out-gunned in the battle for the assets of a delinquent taxpayer. In fact the great majority of the federal priority cases have involved contests with state and local taxing authorities, with the federal government nearly always winning.

Although real-property taxes have been recognized as giving rise to "choate" liens, which prevail over liens for subsequently assessed federal taxes,[32] and which are not subordinated to federal claims in insolvency,[33] the courts refuse to go further and recognize the almost universal rule of state law which places real-property taxes ahead of pre-existing liens. Therefore, a real-property-tax lien is subordinate to a lien for any federal tax previously assessed;[34] and, if the property has been included in the gross estate of a decedent or has been the subject of a gift, a real-property tax assessed after the death or after the gift will be subordinate to the federal estate or gift tax, even if such tax has not yet been assessed.[35]

In the case of most other taxes, the state and local governments have fared badly in competition with federal claims, even where the state or local tax is assessed before the federal tax. The

[24] I.R.C. § 5004.

[25] 31 U.S.C. § 191 (U.S. Rev. Stat. § 3466).

[26] See New York v. Maclay, 288 U.S. 290, 294 (1933); United States v. Gilbert Associates, 345 U.S. 361, 365 (1953).

[27] Exchange Bank & Trust Co. v. Tubbs Mfg. Co., 246 F.2d 141 (5th Cir. 1957), *cert. denied*, 355 U.S. 868 (1957).

[28] Muniz v. United States, 155 N.E.2d 140 (Ind. App. 1958); *In re* Decker's Estate, 355 Pa. 331, 49 A.2d 714 (1946).

[29] United States v. Atlantic Municipal Corp., 212 F.2d 709 (5th Cir. 1954).

[30] 11 U.S.C. § 107(b) and (c).

[31] 11 U.S.C. § 104(a)(4). See Missouri v. Ross, 299 U.S. 72 (1936).

[32] United States v. City of New Britain, 347 U.S. 81 (1954).

[33] *Supra* note 29.

[34] United States v. City of New Britain, *supra* note 32.

[35] Michigan v. United States, 317 U.S. 338 (1943).

requirement that a non-federal lien, to be " choate," must attach to specifically identified property normally means the defeat of a claim for a state income tax, franchise tax, sales tax, gasoline tax or other non-property tax. Those taxes frequently are liens on " all the property used in the business " or on " all property belonging to the taxpayer," and are deemed inchoate.[36] Even where the state lien on all the taxpayer's business property was recorded and was good against bona fide purchasers—substantially like the federal tax lien—the state lien was held to be inchoate.[37] Doubt has been cast even on a state lien which was recorded against an itemized list of personal property.[38] It has been held that even a sale of personal property pursuant to a state or local tax lien may not be enough to defeat a later federal claim, if title or possession has not passed.[39] On the other hand, a state court has held that, where a state income-tax lien attaches to all the taxpayer's *real estate*, it is choate, on the ground that the requirement of taking title or possession applies only to liens on personal property.[40]

Liens for personal-property taxes are in a shadowy middle ground between *in rem* property-tax liens and general liens for non-property taxes. The decisions on their priority are in hopeless conflict, and do not appear to be reconcilable on the basis of the manner of imposing the tax or the lien therefor under the particular state laws involved.[41]

Frequently, state law provides for the docketing of a state tax assessment as a judgment, thus enabling the tax to be enforced in the same manner and with the same priority as a court judgment, without the need for a judicial proceeding. Although, as noted above, a judgment creditor is protected against a federal tax lien that arose before but was not filed until after the judgment lien arose, the courts do not recognize a non-judicial " judgment " for a state tax as constituting a " judgment " within the meaning of the federal law,[42] and thus a pre-existing unfiled federal tax lien will prevail. Nevertheless, such a provision of state law may be helpful in cases where the state tax achieves the status of a " judgment " *before* the federal lien even arises by assessment, since even a non-judicial " judgment " may become

36 United States v. Texas, 314 U.S. 480 (1941).

37 Illinois v. Campbell, 329 U.S. 362 (1946).

38 United States v. Carroll Construction Co., 41 Wash. 2d 317, 249 P.2d 234 (1952), *remanded*, 346 U.S. 802 (1953). The Supreme Court did not expressly hold such a lien inchoate, but remanded " for consideration in the light of " the *Gilbert* case, *infra* note 39. No subsequent decision of the state court on remand is reported.

39 United States v. Gilbert Associates, 345 U.S. 361 (1953). The *Gilbert* case, like all those cited in notes 36-38, involved the insolvency priority statute, and one court has held that the requirement that title or possession pass has no application in a straight lien priority case, not involving an insolvency proceeding. Gower v. State Tax Commission, 295 P.2d 162 (Ore. 1956). However, the other tests of " choateness," above discussed, have been imported from the insolvency field into the lien priority area (see Kennedy, " The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien," 63 *Yale Law Journal* (1954), p. 905), and the Gilbert test may yet be applied there as well.

40 United States v. South Carolina, 227 S.C. 187, 87 S.E.2d 577 (1955).

41 Personal property tax liens were held *inchoate* in United States v. Waddill, Holland & Flinn, 323 U.S. 353 (1945); United States v. Gilbert Associates, 345 U.S. 361 (1953); Exchange Bank & Trust Co. v. Tubbs Mfg. Co., 246 F.2d 141 (5th Cir. 1957), *cert. denied*, 355 U.S. 868 (1957). But they were held *choate* in Evans v. Stewart, 245 Iowa 1268, 66 N.W.2d 442 (1954); Chrysler Corp. v. Long & Long, 171 F. Supp. 541 (D.C. Mich. 1958).

42 United States v. Gilbert Associates, 345 U.S. 361 (1953).

a choate lien, having priority at least as against the taxpayer's real estate.[43]

" Super-Priorities "

When we criticize the strong-arm priorities of the federal government we must not forget that the states have led the way in granting themselves priorities over the antecedent interests of third parties, and we should not be surprised that, when the play is rough, the bigger boy takes the marbles. It is not uncommon for the states to make their income- and franchise-tax liens effective, not at the time of assessment, but as of the close of the taxable year or the due date of the return, thus displacing private liens arising in the interim. It is clear, however, that, if the state lien is " choate " at all, it cannot become so, as against a federal tax lien, prior to the fixing of the amount by assessment.[44] A more extreme type of provision is that which makes the state or local tax lien a " first lien," preferred even over liens existing before the period with respect to which the tax was assessed. Such provisions are almost universal, and probably fully justified, in the case of real-property taxes; but like provisions are made in some states with respect to other taxes which are not imposed on the property at all, such as certain taxes in Pennsylvania and New York.[45] As we have seen, such " super-priorities " are ineffective against federal claims.[46]

That does not mean, however, that the state or local taxing authorities may not profit from provisions giving them " first liens " or relating their liens back to an earlier date, for they may be the beneficiaries of the operation of the rules of " circular priority." " Circular priority " arises where A is prior to B, who is prior to C, who by state law is prior to A, so that every lien is ahead of one of the others and behind another, in an endless circle. Suppose there is a $15,000 mortgage, which has priority over a $20,000 federal tax lien, which is superior to a lien for $5,000 in delinquent property taxes. State law prefers the property tax over the mortgage. Suppose the property is sold for $21,000, net. Some early decisions held that, since the federal tax was behind the mortgage, it must be behind everything that ranks ahead of the mortgage. Thus, both the $5,000 property tax and the $15,000 mortgage would be satisfied, leaving only $1,000 of the proceeds for the Federal Government. The Supreme Court, however, held that such state laws could not be given the effect of cutting down the amount to which the United States was entitled by virtue of its priority under federal law.[47] The United States was entitled to whatever was left—i.e., $6,000—after setting aside the amount of the $15,000 prior mortgage. Then it was up to state law to divide the $15,000. The result was that the local government satisfied its claim for property taxes out of the mortgagee's share of the proceeds. Thus,

[43] United States v. South Carolina, 227 S.C. 187, 87 S.E.2d 577 (1955). Ordinarily a judgment gives rise to a lien on *personal* property only upon execution. Ersa, Inc. v. Dudley, 234 F.2d 178 (3d Cir. 1956).

[44] Mass. Bonding & Ins. Co. v. New York, 259 F.2d 33 (2d Cir. 1958); United States v. Reese, 131 F.2d 466 (7th Cir. 1942); United States v. South Carolina, 227 S.C. 187, 87 S.E.2d 577 (1955).

[45] N.Y. Tax Law § 213; Penn. Stat. Title 72, § 3342. See Marshall v. New York, 254 U.S. 380 (1920); International Harvester Credit Corp. v. Goodrich, 350 U.S. 537 (1956).

[46] United States v. City of New Britain, 347 U.S. 81 (1954); New York v. Maclay, 288 U.S. 290 (1933).

[47] United States v. City of New Britain, 347 U.S. 81 (1954).

wherever there are mortgages, judgments or other liens which outrank the federal lien, it is not the local taxing authority but the prior creditor who suffers from the federal priority over later property taxes. The same result would follow in the case of a corporate franchise tax which ranks as a "first lien" under state law, or in the case of a state or local lien which, by "relation back," outranks some earlier private lien that is ahead of the federal lien.

II. AMERICAN BAR ASSOCIATION RECOMMENDATIONS

Many business and professional organizations, alarmed at the inequities of the growing body of decisions permitting the satisfaction of federal taxes at the expense of others having prior claims to the taxpayer's property, have clamored for remedial legislation. The American Bar Association took the lead in the effort and, after exhaustive study, recommended a comprehensive statute covering federal tax liens, insolvency priorities, and procedures.[48] The proposal includes a number of recommendations affecting the priorities of state and local taxes as against federal claims.

Proposed Treatment of Real Property Tax Liens

The most significant, and no doubt the most controversial, proposal in this area relates to real property taxes and special assessments for public improvements. It is proposed that such taxes and assessments be granted priority over federal tax liens on the property assessed, even if the federal tax lien arises first.

Such proposal finds its justification in the philosophy behind the almost universal rule of state law, that a real property tax is imposed upon the whole property, regardless of the number and nature of the interests into which it may be divided.[49] The reason the "superpriority" of real property taxes is now ineffective against federal tax liens is that the United States is considered the "owner" of an interest in the property, which the state and local governments have no power to tax.[50] But the United States can grant its consent to the taxation of property owned by it, and often has done so, as a matter of equity and good policy, where federally-owned property is in essentially private use (as distinguished from uses that confer a direct benefit on the local community). In particular, Congress has given such consent where the government's interest in the property results from the collection of a debt (e.g., the foreclosure of a federally-insured mortgage).[51] Such provisions have been construed to include consent to the priority of real-property taxes imposed after the federal lien attached but before it was enforced.[52] Consistently with the policy of those statutes, Congress is asked to consent to the priority of state and local taxes on property which the federal tax

[48] See *Final Report of the Committee on Federal Liens* (approved by the House of Delegates February 23, 1959), American Bar Association, 1155 East 60th St., Chicago, Illinois. A summary of the proposals is found in Plumb, "Federal Tax Liens: Proposed Revision of the Law," 45 *American Bar Association Journal* (April 1959) p. 351. Bills to effectuate the proposals have been introduced in both houses of Congress as H.R. 7914, H.R. 7915, and S. 2305.

[49] See Southern Ohio Sav. Bank v. Boice, 165 Ohio St. 201, 135 N.E.2d 382 (1956).

[50] United States v. City of Greenville, 118 F.2d 963 (4th Cir. 1941).

[51] See 7 U.S.C. § 1024; 12 U.S.C. § 1714; 38 U.S.C. § 694j(a)(6).

[52] United States v. Mays, 264 F.2d 449 (10th Cir. 1959); Byram Holding Co. v. Bogrea, 63 A.2d 822 (N.J. Super. Ct. 1949).

collector permits (sometimes for extended periods) to remain in private use, enjoying the benefits of local protection and services, while the owner seeks to work off his federal tax liability.

The case is particularly strong for "super-priority" of special assessments. At least in theory, the special assessment is imposed because of the enhancement of the value of the particular property resulting from the public improvement. If the federal tax lien is permitted to exhaust the proceeds of the property, leaving the special assessment unsatisfied, the federal government is unjustly enriched to the extent that the value was so enhanced.

A secondary reason for proposing to recognize "super-priority" for real-property taxes and special assessments is that it will eliminate, in many cases, the very troublesome and inequitable "circular priority" situation, above described. At present, a mortgagee who conceives that he is protected by an ample cushion of equity may find such equity consumed by an after-arising federal tax lien, which causes the mortgagee to bear the burden of subsequent real-property taxes and special assessments, out of his share of the proceeds.[53] This rule, furthermore, has created a difficult administrative problem for the federal tax collector, that is rarely justified by the amount of property tax involved in any individual case.[54]

One thing the proposal does not do, but which should be considered in the future, is to provide for Congressional consent to the taxation of real property after the United States has bought the property at its own tax sale. Such property is ordinarily held for at least a year before resale,[55] and in exceptional cases it may be retained for years (perhaps leased by the United States to the former owner), meanwhile bearing no local property taxes.[56]

Proposed Treatment of Other State and Local Taxes

In the case of taxes other than real-property taxes, it is proposed to abolish the present "double standard" of choateness and to permit federal, state and local taxes to compete under the same rules. Since the federal tax lien dates its priority (with exceptions not here pertinent) from the time when the tax is assessed, the priority of a state or local tax would also date from the time when it is assessed or otherwise determined (unless the determination does not give rise to a lien, under state law, until a later date). It would no longer be required that the state or local lien attach to specifically identified property, or that the amount be fixed beyond possibility of further controversy—requirements that have never been imposed with respect to the federal tax lien.

[53] *Supra*, at note 47.

[54] See *Final Report of the Committee on Federal Liens*, *supra* note 48, at p. 30.

[55] Treasury Regulations § 301.7506-1(b)(1).

[56] In one case pending in the District of Columbia, the Federal Government is said to have purchased property at its tax sale, rented the property to the former owner, and kept it off the local tax rolls for over 21 years.

In Borock v. City of New York, F.2d (2d Cir. 1959), it was held that if the United States, in foreclosing its tax claims, elects not to sell the property but to have the business operated by a receiver (I.R.C. § 7403(d)), the receiver is subject to real property taxes accruing during the receivership (28 U.S.C. § 960). The court stated that the Government cannot perpetuate the advantage of tax exemption, to the detriment of competitors and of the local government, by operating the property through a receiver rather than selling it. Yet the same policy considerations would apply if the Government buys in the property and leases it to an operator.

The proposal would not, however, go further and require the filing of notice of the federal tax lien in order that it may prevail over a state or local lien, even when state law gives a tax determination the effect of a judgment. Since the aim is to let all tax liens compete under the same rules, it would not be fair to require that the federal lien be filed, since no such requirement is proposed to be imposed on state and local liens. Taxing authorities do not acquire their liens in reliance upon the state of the record title, and a requirement of filing of notice, by either taxing body to bind the other, would be unnecessary and inappropriate. Furthermore, such a requirement might have the undesirable result of forcing the competitive filing of notices of lien in situations where, with forbearance, collection might have been effected by all concerned without destroying the taxpayer's credit and his business.

In keeping with the policy of applying the same rules to all, the proposal would not recognize (as against the federal tax lien) state laws making a tax lien effective as of a date before its assessment, nor those which make state or local taxes (other than for real-property taxes) " first liens " ahead of existing liens. It is true that the failure to recognize such rules will result in some " circular priority " situations, in which a prior mortgagee or other lienor may be the innocent victim. But, except in the case of the real-property tax, where peculiar justification exists, no reason appears why the federal government should submit to a " strong-arm " priority provision of state law, merely to protect innocent third parties whose complaint should properly be directed to their state legislatures.

Proposal with Respect to Estate and Gift Tax Liens

The American Bar Association proposal would apply to the federal estate- and gift-tax liens rules of priority similar to those proposed for the general tax lien. Accordingly, real-property taxes and special assessments would be preferred over liens for federal estate and gift taxes, even though the latter first arose. Liens for other state and local taxes would be preferred over federal estate and gift taxes if the state or local tax was assessed and became a lien before the time of the death or of the gift.

Proposed Rule in Insolvency

The present absolute priority of the federal government in insolvency proceedings has not been re-examined by Congress in 160 years, despite its checkered history of judicial interpretation.[57] In contrast, the rules of priority in bankruptcy reflect the carefully considered policy of Congress, re-studied frequently since their adoption in 1898, a century after the insolvency law. Accordingly, it is proposed to bring the insolvency rules in line with those prevailing in bankruptcy. However, since the priorities of *non-federal* claims in receiverships, assignments for creditors, and insolvent decedents' estates are governed by state law, it is not proposed to import the bankruptcy rules *in toto*, but only to grant consent to state-enacted rules placing federal claims in no worse position than they would occupy in bankruptcy. Thus, conforming state legislation may be necessary in some instances to make the proposed new rules fully effective.

Accordingly, if state law so provides, funeral expenses and certain wage claims

[57] See Kennedy, *loc. cit. supra* note 39.

(to the extent preferred in bankruptcy) could be paid ahead of federal claims which had not become liens before the proceeding commenced, and state and local tax claims could be paid on a parity with federal non-lien tax claims —all with a preference over general unsecured creditors.

Administrative expenses could also be paid ahead of unsecured federal claims. It would be expressly provided, resolving present uncertainties,[58] that administrative expenses include federal, state and local taxes incurred during administration, without distinction among them.

However, federal, state and local taxes which had become liens before the proceeding commenced would retain the priority thus achieved (in conformity with the proposed lien priority rules above set out), and would not be affected by the intervention of insolvency.

Enforcement of Liens

A proposed procedural change of particular interest to state and local governments relates to non-judicial foreclosure of liens, including state and local tax liens, having priority over federal claims. Resolving grave uncertainties under present law, it would be provided that such a non-judicial sale, under process of law, shall have the same effect in discharging a subordinate federal lien or encumbrance as local law may provide with respect to such matters. A condition would be imposed, however, that the United States must (with certain exceptions) be given 60 days' advance notice of the sale, so that it may protect its interests.

That proposal would permit the enforcement of state and local tax liens without the necessity of going to court in every case to clear the title of a subordinate federal lien.[59] However, the proposal would not go so far as to permit removal of a subordinate federal lien by strict foreclosure of a state or local tax lien, without sale.[60]

Some Problems Left Untouched by the Proposals

There are a number of special problems that the Special Committee of the American Bar Association left unresolved, finding that it was unable, in the time available, to obtain the necessary background and perspective with respect to 50 different state laws that affect the problems. These matters ought to be

[58] State and local taxes incurred during administration were held to be administrative expenses in Petition of Gilbert Associates, 97 N.H. 411, 90 A.2d 499 (1952), *rev'd on another point,* 345 U.S. 361 (1953); Brown v. Comm'r, 74 F.2d 281 (10th Cir. 1934); Central Vermont Ry. v. Marsch, 59 F.2d 59 (1st Cir. 1932); United States v. Pinto, 59-1 U.S.T.C. ¶ 9402 (D.C. Mich. 1959). *Contra: In re* Mills Co., 57-1 U.S.T.C. ¶ 9564 (D.C. Miss. 1957); Hill v. Grissom, 299 Fed. 641 (D.C. N.C. 1924). Even if they are recognized as administrative expenses, they may be subordinate, under present law, to federal taxes incurred during administration (Wire Wheel Corp. v. Fayetteville Bank & Trust Co., 30 F.2d 318 (7th Cir. 1928)), rather than equal, as in bankruptcy (*In re* Lambertville Rubber Co., 111 F.2d 45, 49-50 (3d Cir. 1940)).

[59] Present law permits the removal of subordinate federal liens by judicial sale. 28 U.S.C. § 2410. Although some decisions have permitted such removal by non-judicial sale under the terms of a mortgage or deed of trust (United States v. Boyd, 246 F.2d 477 (5th Cir. 1957), *cert. denied,* 355 U.S. 889 (1958); United States v. Brosnan, 264 F.2d 762 (3d Cir. 1959), *cert. pending*), that position has been challenged in other courts. United States v. Bank of America, 265 F.2d 862 (9th Cir. 1959), *cert. pending*. It is questionable whether even the rule of *Boyd* and *Brosnan* would enable removal of the federal lien by a state or local tax sale, since they rely on the theory that the taxpayer, under the terms of the security, had only a conditional title at the time the federal lien attached.

[60] Strict foreclosure of a state or local tax will not discharge a federal lien under present law. Integrity Trust Co. v. United States, 3 F. Supp. 577 (D.C. N.J. 1933); Borough of Kenilworth v. Corwine, 96 F. Supp. 68 (D.C. N.J. 1951).

further studied by those most interested and qualified to deal with them.

One relates to those state and local taxes which, in practical effect if not always in legal theory, are collected by a businessman from the general public (sales taxes and special excises) or from his employees (income taxes withheld). If a federal tax lien exists before such state or local tax is collected from the public or the employees, or arises before the formal assessment of the state or local tax, the federal government will (even under the proposed legislation) profit from the amounts so collected for the benefit of state or local government —at least in the absence of effective segregation of the fund in trust.[61] It would be more equitable to recognize a " super-priority " for that type of tax; but there are many problems to consider, such as the extent of tracing to be required where the collected fund has been dissipated and where a " super-priority " would thus cut down the amount that would otherwise have been available for the federal claim.

Another problem is whether liens for personal-property taxes warrant the same preference that is proposed to be accorded real-property taxes. Although they are measured by property, personal-property taxes seem more appropriately regarded as " presonal " levies, like income taxes, rather than impositions *in rem* on specific assets. Liens for such taxes frequently are not confined to the specific property taxed. Conceivably, further study might establish that, at least in some special circumstances, personal-property taxes are entitled to preferential treatment. But, in the absence of sufficient study, the Committee felt that it had gone as far as it reasonably could when it recommended conferring a " super-priority " on real-property taxes alone, and treated personal-property-tax liens like those for state income taxes and other personal taxes.

Still another problem considered but not answered by the Committee involves the relative priority of federal and state claims for unemployment taxes or contributions. The federal tax was adopted, not as a means of raising federal revenue, but to encourage the adoption of state systems. Payments into state systems may be applied as credits against 90 per cent of the federal tax (with additional credits, above actual payments to the state, permitted under certain conditions).[62] If the taxpayer is unable to pay the state claim, no credit is allowed.[63] Since the federal claim has priority over the state claim in an insolvency proceeding, the federal government may collect and retain up to 100 per cent of the unemployment tax, to the exclusion of the state, although a like amount paid by a solvent taxpayer would go 90 per cent to the state and 10 per cent to the United States.[64] Since state unemployment-tax liens are generally considered inchoate, as against a federal lien,[65] the same situation might

[61] Experience under federal law (I.R.C. § 7501) has shown the ineffectiveness of requirements for segregation of " collected " taxes in trust, as a means of establishing priority. See *In re* Frank, 25 F. Supp. 1005 (D.C. N.Y. 1939).

[62] I.R.C. §§ 3302, 3303.

[63] If the payment of state tax is merely untimely, the maximum credit allowable is reduced from 90 to 81 per cent. I.R.C. § 3302(a)(3).

[64] Massachusetts v. United States, 333 U.S. 611 (1948).

[65] Ersa, Inc. v. Dudley, 234 F.2d 178 (3d Cir. 1956); Re Projectron Corp. 58-2 U.S.T.C. ¶ 9653 (D.C. Mass. 1958), *appeal dismissed sub nom.* Massachusetts Division of Employment Security v. United States, 261 F.2d 449 (1st Cir. 1958).

arise even in the absence of an insolvency proceeding, if the state tax collector cannot find sufficient assets after the federal collector has taken the full amount of the tax.[66] Even in bankruptcy, where state and federal tax claims (unsupported by valid liens) rank equally, the amount available for the state's claim is contingent upon the amount allowed on other tax claims having equal priority, including the federal unemployment tax, which in turn depends on the amount which can be paid to the state (since the allowable credit is measured by the state's recovery). An algebraic formula must be used, which results in a larger federal share than if the assets were sufficient to discharge all priority claims.[67] What seems needed is some provision for proportionate sharing of whatever can be collected as unemployment tax on behalf of both governments. Unfortunately, the Committee encountered drafting difficulties resulting from the fact that the amount of the liability to the state may be more or less than the 90 per cent credit allowable, and it was forced to defer the problem for later consideration by others who may be interested.

III. THE N.A.T.A. ALTERNATIVE

In 1957, the National Association of Tax Administrators presented to Congress two alternative proposals for achieving greater equity in cases involving conflicting federal, state and local tax claims. Its second alternative was substantially similar to that which was adopted in the American Bar Association proposal—i.e., determining the respective shares of the available assets on the basis of priority of liens, but applying the same standards of "choateness" to state and local liens as to federal liens.

The first alternative suggested by N.A.T.A., although more of a departure from familiar patterns, has great appeal to the writer, as a longer-range objective. It was proposed that—whether in insolvency, bankruptcy or a simple lien case—all assets available for payment of federal, state and local tax claims, on the basis of the priorities of any such governments over private claims, be lumped together and divided *pro rata* among the governments concerned. Congress has already moved in that direction, by providing for proportionate sharing among tax claims in bankruptcy, in the absence of valid liens. The N.A.T.A. proposal would go a step further, and call upon the several governments, as between themselves, to surrender the advantage of pre-existing liens. It has been pointed out that, as between taxing authorities, priority of liens signifies merely that the one with the prior lien has permitted its claim to go delinquent for a longer time.[68] During the sometimes extended period that the holder of the prior lien permits the delinquent taxpayer to operate, in an effort to earn enough to pay off his taxes, he enjoys the benefits of the services of all three levels of government, which all contribute in some degree to the earning of his income; yet only those governments holding the most stale claims may be satisfied.

Although the different levels of government cooperate in many ways in the determination and collection of taxes,

[66] However, in Kusk v. Convair, 58-2 U.S.T.C. ¶ 9827 (D.C. Tex. 1958), the court allowed payment of the state claim out of the fund levied upon for a federal unemployment tax assessment (in which no credit for state tax had been allowed).

[67] United States v. New York, 315 U.S. 510 (1942).

[68] 3 Collier, Bankruptcy ¶ 64.403.

they often become bitter competitors when the fund available for collection is inadequate to satisfy all their claims. This should not be. There may be legitimate differences of opinion concerning the proper scope of the functions of each level of government; but there can be no doubt in anyone's mind that the functions actually performed by each are of vital importance to the welfare of the nation. Schools, roads, police and fire protection, sanitation, and the other functions of state and local government are as important to our lives as those of the federal government. When the assets of a delinquent taxpayer are insufficient to satisfy all his taxes, the fairest division would disregard the accident of the time when each was assessed, and would divide proportionately the assets available to all the taxing authorities.

That, however, is an ideal to be hoped for. The American Bar Association has taken the more conventional, and therefore probably more attainable approach, pitching its appeal to fairness on the adoption of a "single standard" of lien priority, rather than on an egalitarian ideal that views lien priorities as irrelevant as between governments.

The Bar proposal does much to achieve equity for state and local taxing authorities. It is now up to them to let their Congressmen know that this was no mere academic exercise, that there are real problems here to which Congress ought to address itself, and that these proposals,[69] or some modification of them, ought to be enacted without undue delay.

[69] H.R. 7914, H.R. 7915, and S. 2305, 86th Cong., 1st Sess.

TAX BURDENS IN COMMON MARKET COUNTRIES *

JOHN MOSS

I

THE Treaty Establishing the European Economic Community limits the exercise of the fiscal powers of the members [1] and provides for the " harmonization " of their systems of indirect taxation [2] and for the reform of direct taxing which, in the opinion of the Commission of the Community, " distorts the conditions of competition in the Common Market and thereby causes a state of affairs which must be eliminated." [3] Since concerted customs action under the Community began on January first of this year,[4] preceded by only two days by the sudden general easing of the European convertibility restrictions to which the postwar world had become accustomed,[5] there has passed little time for directing attention to problems other than the initial ones confronting the founding governments: the coordination of their tariffs and the abolition of their import-export quotas, which, indeed, they have allowed themselves twelve to fifteen years to achieve.[6] But, as customs and exchange barriers disappear, the economic variations remaining among the six countries, including those resulting from their internal tax systems, will assume increasing importance in determining business decisions.[7] It is then that members' legislative interferences with the facts of comparative advantage will be most likely to come under Commission scrutiny and be pronounced harmful. It is

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1 TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, March 25, 1957 (hereinafter cited as TREATY), arts. 95-98. English ed., publ. by the Secretariat of the Interim Committee for the Common Market and Euratom, Brussels, at pp. 93-94 (1957), 298 United Nations Treaty Series 53 (1958); French original, 294 UNTS 75-76 (1958). Entered into force January 1, 1958 (N. Y. Times, Jan. 1, 1958, p. 2).

2 TREATY, art. 99. Engl. ed. at p. 94, 298 UNTS 53, 294 UNTS 76.

3 TREATY, art. 101. Engl. ed. at pp. 95-96, 298 UNTS 54, 294 UNTS 77.

4 N. Y. Times, Jan. 2, 1959, p. 37 (late city ed.).

5 *Id.*, Dec. 30, 1958, pp. 1, 2, 3, 4 (late city ed.).

6 TREATY, art. 8, §§ 1, 3, 5-7; arts. 14, 32, 34, 36. Engl. ed. at, respectively, 19, 20, 21, 30-31, 40-41, 43; 298 UNTS at 17, 18, 20, 27, 28, 29; 294 UNTS at 27, 28, 31-33, 40-41, 42, 43. However, the Commission has already summoned experts to attempt to define taxes " having an effect equivalent to customs duties " under TREATY, art. 13, para. 2, 1 Droit européen 189 (1958), and has stated its intention to gather the information needed to pursue the " harmonization " policy. European Economic Community Commission, First General Report on the Activities of the Community, January 1, 1958 to September 17, 1958, at p. 45 (1958). A helpful critique of EEC operations will be found in Camps, The First Year of the European Economic Community, *passim* (1958).

7 Kerlan, Fiscalité et marché commun européen, 51 Revue de science financière 96 (1959).

then, also, that members themselves will most wish to ensure that their fiscal arrangements, arrived at upon primarily domestic considerations, do not impair any intra-Community position which capital, management, or labor, situated within or imported into their respective territories, might otherwise enjoy.[8]

"Harmonization" will mean more than a further step toward the political ideal of "an ever closer union among the European peoples" declared in the Establishing Treaty's preamble, impelled by Europe's bloody history, and encouraged by the postwar successes of the Marshall Plan, the post-Marshall Plan OEEC, and the Council of Europe.[9] It will also fulfill the impulse of a powerful but disorganized region for rationalization and competitive strength in a world now dominated, in fact or threat, by the younger and more progressive economies of the United States and the Soviet Union,[10] to whom, possibly, China may eventually be added. Finally, this policy can better bind the whole West closer together, as Britain and America find, in EEC, not only a vigorous rival, but an imaginative trading partner, with a healthy appetite for capital and products,[11] and, perhaps, even workers, and fortified by its goals and achievements against internal political disintegration or subversion by extremist factions.[12]

Taxation, today a basic instrument of economic policy as well as a means for supporting the State,[13] is relatable to many general provisions, woven throughout the fabric of the EEC Treaty, which are designed to promote the free flow of goods,[14] "persons, services, and capital" [15] among the member nations of the Community. For example, tax laws can certainly give rise to benefits which may be considered "aids granted by States," within the meaning of Article 92 of the Treaty, subject to review by the organs of the Community under Article 93 on the grounds that they are "incompatible with the Common Market" because they "adversely affect . . . trade between member States" [16] or are "applied in an improper manner." [17] Indeed, Paragraph 2 of Article 92, in defining certain "aids" as "compatible with the Common Market," mentions "aids granted to the economy of certain regions of the Federal Republic of Germany affected by the division of Germany, to the extent

[8] The EEC aims include the freeing of "movement of persons, services, and capital" within the Community. TREATY, art. 3 (c). Engl. ed. at 17, 298 UNTS 16, 294 UNTS 25.

[9] Ouin, The OEEC and the Common Market, pp. 5, 7, 31, 32 (1958). See also, *passim*, L'Huillier, La coopération économique internationale (1959), for a study of events involving GATT, EPU, the World Bank, IMF, and EEC; Cabot, Common Market—Economic Foundation for a U. S. of Europe?, *passim* (pub. by Committee for Economic Development) (1959); Sainte-Lorette, Le marché commun 219 (1958); and Williams, The Common Market and Its Forerunners, *passim* (1958).

[10] The First National City Bank of New York, The European Common Market 4 (1958); The Contracting Parties to the General Agreement on Tariffs and Trade, The Possible Impact of the European Economic Community . . . upon World Trade, *passim* (1957).

[11] The First National City Bank of New York, *Id.*, 17.

[12] European Movement, The Economic Future of Europe 26 (1954).

[13] A good history of the emergence of taxation as an instrument of policy will be found in Kennedy, English Taxation 1640-1799, *passim* (1913).

[14] TREATY, Part Two—Bases of the Community, Title I, *passim*. Engl. ed. at 25, 298 UNTS 18, 294 UNTS 29.

[15] TREATY, Part Two—Bases of the Community, Title III, *passim*. Engl. ed. at 57, 298 UNTS 36, 294 UNTS 52.

[16] TREATY, art. 92, para. 1. Engl. ed. at 90, 298 UNTS 51, 294 UNTS 72.

[17] TREATY, art. 93, para. 2. Engl. ed. at 91, 298 UNTS 52, 294 UNTS 73.

that such aids are necessary in order to compensate for the economic disadvantages caused by such division,"[18] perhaps referring to certain tax reliefs granted to businesses located near the Iron Curtain.[19] And Paragraph 3 of the same article, in listing "aids" which "may be deemed to be compatible," includes "aids intended to facilitate the development of . . . certain economic regions,"[20] which describes perfectly the tax concessions offered by Italy to improve her South, which have resulted, in the words of one analyst, in the appearance of a number of "honorary Southern areas" in her North.[21]

In contrast to the number of general Treaty provisions affecting taxation, those which purport to deal with it specifically are few. Except for Article 220, found in Part Six—General and Final Provisions, which commands the Member States to negotiate with each other to ensure "the elimination of double taxation within the Community," they are grouped together in a brief chapter of five articles, appearing under Part Three—Policy of the Community, Title I—Common Rules, as Chapter 2—Fiscal Provisions. The articles prohibit internal taxation imposing discriminatory or protective charges differentiating between products of Member States and domestic products,[22] the accomplishment of such discrimination by export drawback[23] or by the establishment of average rates of turnover tax for specific products,[24] and the execution of other compensatory measures in regard to imports or exports unless the prior approvals of the Commission and Council have been obtained.[25] Finally, the Commission and Council are directed to undertake the "harmonization" of indirect taxation.[26]

The Treaty is yet too young in operation for its language to have received much legal construction, and commentators have generally agreed that "harmonization," in particular, is a concept which may be defined only through a gradual process of attempting to apply it, and does not signify merely an attempt to "equalize,"[27] or to substitute a single uniformity for the present diversity of tax systems. It has been pointed out[28] that [E]ach country's system of taxation is based on and is interwoven with its people's sense of justice and the character of economic life. Alterations in [such a] system can only be introduced very gradually. . . . In democratic states the right to approve tax legislation (and the budgetary rights connected therewith) are parliamentary

[18] Engl. ed. at 90, 298 UNTS 51, 294 UNTS 72.

[19] Federation of British Industries, Taxation in the Proposed European Free Trade Area (hereinafter cited as FBI) 90 (2nd ed., 1958).

[20] Engl. ed. at 91, 298 UNTS 51, 294 UNTS 72.

[21] Pavia, "Italian Taxes on Income and Investments," in American Management Association, Setting Up Operations under the Common Market, p. 54 (1958).

[22] TREATY, art. 95. Engl. ed. at 93, 298 UNTS 53, 294 UNTS 75.

[23] TREATY, art. 96. *Id.* Engl. ed. at 93, 298 UNTS 53, 294 UNTS 75.

[24] TREATY, art. 97. Engl. ed. at 93, 298 UNTS 53, 294 UNTS 75.

[25] TREATY, art. 98. Engl. ed. at 94, 298 UNTS 53, 294 UNTS 76.

[26] TREATY, art. 99. Engl. ed. at 94, 298 UNTS 53, 294 UNTS 76.

[27] 6 International Confederation of Free Trade Unions Economic and Social Bulletin, No. 4, p. 12 (1958).

[28] Caillez, Carroll, and van Soest, "De l'élimination des obstacles d'ordre fiscal au rapprochement des systèmes économiques européens," in 4th International Tax Congress, 15 Cahiers de droit fiscal international 45 (1950).

prerogatives of first order and it seems impossible to bring this prerogative into accord with fruitful negotiations for a convention [establishing a uniform tax system] . . . ." And it has been suggested that fiscal adjustment itself may not be an absolute condition of total integration, in view of the supposed example set by the state governments in the United States.[29] Probably, however, federal regulation of interstate commerce, the fact that state taxes have become important only in recent years after the development of our national economy, and the deductibility of many state taxes in computing taxable income for federal purposes have in fact, created a situation equivalent to continuing "adjustment" in this country.

The "harmonization" of indirect taxing, and the reform of direct taxing which "distorts," have been entrusted to the Commission, which studies problems, negotiates with Member States, and, if necessary, makes recommendations to the Council, and to the Council, which is empowered to issue directives to the governments concerned.[30] In the first years of the Community, the Council must, it is true, act unanimously;[31] but, beginning with the "second stage," which is scheduled to take effect some time between 1962 and 1965,[32] a majority vote will be sufficient.[33] It is of interest to mention that the enforcement of Council directives may in some of the countries concerned be achieved in suits in national courts by private parties affected, since constitutional provisions may provide for the automatic execution of the Treaty upon domestic law.[34]

Whether the Six can attain their repeatedly-emphasized aim of integrating Europe politically, economically, and socially,[35] and whether they should try, or rather limit their plans to those which would satisfy the looser idea of "customs union," are questions beyond the scope of this inquiry. Working instead within the subject of taxation, upon the assumption that "harmonization" of both direct and indirect taxes will be attempted with the view of facilitating full economic union and giving full play, so far as concerns taxation, to factors of comparative cost,[36] we will attempt to begin studying the present differences, from country to country within the Common Market, of tax burden laid upon domestic taxpayers and their activities.

At the outset, it is essential to exclude all nonfiscal considerations, such as the economics of demand curves, the availability of natural resources, and matters of language, traditions,[37] and national

29 Communauté européenne du charbon et de l'acier, Assemblée commune, Informations mensuelles, avril 1956, at p. 69.

30 TREATY, arts. 99, 101; Engl. ed. at 94, 95; 298 UNTS 53, 54; 294 UNTS 76, 77. Cartou, Le marché commun et le droit public 82, 108 (1959).

31 TREATY, n. 30 *supra*.

32 TREATY, art. 8. Engl. ed. at 19, 298 UNTS 17, 294 UNTS 27.

33 TREATY, art. 101. Engl. ed. at 95, 298 UNTS 54, 294 UNTS 77.

34 Croquez, Aspects juridiques du marché commun III, 1 Droit européen 100, 103 (1958).

35 European Economic Community Commission, First General Report on the Activities of the Community, January 1, 1958 to September 17, 1958, at p. 9 (1958); Willemetz, L'harmonisation des législations, 1 Droit européen 176 (1958); Cosciani, Dépenses publiques et contribution de l'Europe fédérée, in Union européenne des fédéralistes, Economie de la fédération enropéenne 66 (proposal to give taxing power to the Community itself) (1952); see also European Customs Union Study Group, 1 General Report of the Economic Committee 54-55 (1948).

36 See Council of Europe, Research Directorate, The Present State of Economic Integration in Western Europe 10 (1955).

37 Relevance noted by Kerlan, *op. cit. supra* n. 7, at 100.

political moods, though to the extent that the tax laws reflect, rather than shape, such factors, the exclusion can be only partial. One must also note the uncertainties of research made ambiguous by the fragmentariness and imprecision of statistical and other data; the necessity of carrying on work in four languages besides English, and in six distinct legal systems; the constant fact of legal and technological change; and the sheer number of factors for consideration before a comprehensive picture can be drawn, in regard to which, many assumptions will have to be attempted with what has been justly called "extreme artificiality."[38] For example, a short list of relevant legal considerations would include whether the taxpayer were a resident, a national, or a nonresident foreigner; whether a juristic person, a partnership, or an agency; whether its capital, if a business, were newly subscribed and growing, or not; whether the capital were equity or loan, realty, tangible personalty, or intangible personalty, and to what extent; whether plant were new or obsolescent, and whether of some, perhaps critical, type, requiring special tax treatment; whether the payroll numbered ten, one hundred, or one thousand; whether the main business were the production of basic materials, the manufacture of finished goods, servicing, or selling; whether supplies came from the country in which located, from elsewhere within the EEC, from the United States, or elsewhere; whether the supplies consisted of foodstuffs, of raw materials, or of semi-manufactures; whether, within the country, the business were located in communities of a certain size, or in particular geographical areas; whether it were wished to distribute 10 per cent, 50 per cent, 75 per cent, or all of the earnings; whether the profits were nearer $25,000, $250,000, or $2,500,000; whether national dividend taxes, if any, were creditable against shareholders' income taxes, and to what extent; whether the shareholders were located in the country, in the EEC, in the United States, or somewhere else; and whether, and where, the business had a parent company or a subsidiary. This list would require analysis of more than two hundred million combinations. Nevertheless, all experimentation faces the problem of selection and assumption, and a properly limited study may prove fruitful.[39]

The present article involves the comparison of quantities which, it is hoped, approximate the total tax burden (taking into account national and important local taxes on income, property, sales, and payrolls) borne by one particular kind of taxpayer: the limited liability company, here seen as taxed, by right or by proper election,[40] as if it were a corporation. This is the form of business most commonly chosen by investors,[41]

[38] FBI at 1.

[39] See, for examples, La situation fiscale des sociétés dans les pays du marché commun, I Droit européen 111 (1958); Aprath *et al.*, Le bilan et la comptabilité en droit commercial et fiscal, in 12th International Tax Congress, 37 Cahiers de droit fiscal international 501, 529, 556, 579 (Germany, Belgium, France, Netherlands) (1958); OEEC, European Productivity Agency, Comparison of Taxation Systems in Fifteen OEEC Countries; Effects of Legislation on Productivity, *passim* (1954); League of Nations, Taxation of Foreign and National Enterprises (France, Germany, Belgium, Italy, Luxembourg, Netherlands, U.S.A., Massachusetts, New York, Canada, Japan, Mexico), *passim* (1932, 1933); League of Nations Economic and Financial Commission, Report on Double Taxation, *passim* (1923).

[40] E.g., in France, under Code général des impots, art. 206, para. 3.

[41] Ilardi, Fiscal Provisions Regarding Companies in Italy, in 2 Banco di Roma, Foreign Private Enterprise in Italy 47, 49 (1957); Bille, The Tax Burden on Business Profits in Six Countries [Sweden, Finland,

hence the utility of its study here. Without examining or disregarding differences which exist in corporate and partnership law among the EEC countries, it has been assumed that all forms fitting this description, and in particular the société anonyme, the Aktiengesellschaft, the société à résponsibilitée limitée, and the GmbH, have been included.[42] For application of the results of this examination to particular companies, the actual business structure under the particular national law is, of course, the important element to consider.[43]

Questions of economic interpretation of the effect of taxation, such as whether the burden of a given tax is " shifted " by the person formally liable for its payment, depending as they may upon momentary circumstances of competition,[44] have been avoided, as has been coverage of special fiscal provisions for benefit or control which governments may have granted or imposed by way of subsidy, export refund, customs duties and quotas, currency revaluation, exchange control, extraordinary tax, carryovers and carrybacks,[45] and rules of appraisal. Only annual levies on the general business community have been included, and it has been assumed that labor, materials, and fixed costs attributable to the profits being taxed have already been deducted. Thus, problems of amortization, depreciation, or investment allowance, which fall within the calculation of costs, are assumed to have been already taken into account. The effects of tax treaties[46] are also omitted, it being further assumed that all owners and sources of income are within the country in which the firm is founded.[47]

For the purposes of the study, model firms with certain fixed characteristics were devised. Each is assumed to have a standard total of assets ($2,000,000); a standard number of employees (200) each paid a standard annual wage of $2000; a standard total of nonfiscal operating costs ($1,600,000); and a standard gross revenue of $2,100,000, including amounts received in sales tax as collecting agent for the government. Profits, after all taxes, are therefore compared both as percentages of gross revenue after deduction of nonfiscal costs, and as percentages of gross revenue after deduction of nonfiscal costs and indirect taxes. The model characteristics were determined arbitrarily as reasonable for recently founded concerns which had passed through any initial period of tax incentives attributable to their establishment, and which would now be subject

Norway, Denmark, France and (West) Germany], 6 Bulletin for International Fiscal Documentation 193 (1952).

42 Bille, *supra* n. 41, at 193.

43 For treatment in English of the relevant law, see Friedman and Pugh (editors), Legal Aspects of Foreign Investment, *passim* (1959).

44 Vedel, Les aspects fiscaux du marché commun, in Droit fiscal, 24 octobre 1958, pp. 1, 6 (1958).

45 As of mid-1958, each EEC country allowed a five-year carryover except Luxembourg (three years) and the Netherlands (six years). Only the Netherlands allowed a carryback (one year). FBI at 46, 80, 91, 102, 108, 115. See, *e.g.*, for France, Code général des impots (hereinafter cited CGI), art. 44.

46 All EEC countries share interlocking bilateral treaties, for the avoidance of double taxation and for administrative assistance, in effect or under negotiation or revision, with each other and with the United States, except Luxembourg-Netherlands and Luxembourg-Italy. See 5 International Tax Agreements at *facing* p. 480 (1954) and 7 ITA 204 (1957), 7 ITA 96 (1956), 6 ITA 173 (1955), 6 ITA 120 (1954) and 5 ITA 54 (1954).

47 For summaries in English of the tax treatment of foreign nationals, assets, and transactions, by countries now in EEC, as of the period 1948-52, see UN Doc. Nos. E/CN.8/45 (Belgium, Luxembourg, 1948), E/CN.8/46/Add. 2 (France, 1948), E/CN.8/46/Add. 10 (The Netherlands, 1949), E/CN.8/46/Add. 16 (Italy, 1950), E/CN.8/46/Add. 17 (Luxembourg, 1950), and E/CN.8/46/Add. 30 (Belgium, 1952).

to the ordinary fiscal provisions of the country in which they were. Variations of composition and distribution of financial statement items, such as amounts for inventory, work in progress, customers' advances, and long term debt, follow from the attempt to exemplify, for each country, A, a manufacturer of finished goods with a sales subsidiary; B, a constructor of large machines and of buildings; C, a producer of refined raw materials with a sales subsidiary; and D, a distributor with a finance subsidiary. The subsidiaries, which represent a standard parental investment of $500,000 illustrate the treatment of $50,000 of dividend income to the parent, when this differs from the treatment of other income. The determinations were arrived at after a comparison of recent financial statements of twenty-three companies, including representatives of investment in the United States,[48] Canada,[49] Puerto Rico,[50] Cuba,[51], Chile,[52] Germany,[53] France,[54] Belgium,[55] The Netherlands,[56] Italy,[57] and Luxembourg.[58] Since no attempt was made to evaluate the systems of financial accounting used in each annual report; since many reports, especially the European ones, left taxes and other expenses unspecified; and since all the companies were relatively large and well-known enterprises, the resulting model figures [59] must be regarded as rough approximations. Moreover, the importance of taxation to the companies from which the figures are taken would normally be far less than to the smaller, perhaps more marginal, firms studied here, located as they are in highly industrialized countries where their political influence and ability to cushion high rates of tax with large quantitative profits, are minimal. The small financial size of the model companies, relative to typical American businesses, is dictated by the fact that, although European heavy industry has tended, and may be further impelled by the Common Market, to consolidate,[60] present new in-

[48] American Investment Co. of Illinois, Semi-Annual Report (unpaged, 1958); Associates Investment Co., 1958 Annual Report 10-12 (1959); Blue Bell, Inc., 1958 Annual Report 10-12 (1959); General Cable Corp., 1958 Annual Report 8-13 (1959); General Motors Corp., 1958 Annual Report 16-17, 28-32 (1959); Maryland Shipbuilding & Drydock Co., 1958 Annual Report 7, 10-12 (1959); The Mengel Co., 1957 Annual Report 4-6 (1958); Standard Brands, Inc., 1957 Annual Report 6, 11-13 (1958); Technicolor, Inc., 1958 Annual Report 19, 32-33 (1959); Wayne Knitting Mills, 1957 Annual Report (unpaged, 1958).

[49] Hudson's Bay Oil and Gas Co., Ltd., Annual Report, 1957 at 6, 8-10 (1958); International Nickel Co. of Canada, Ltd., 1957 Annual Report 14, 18-21 (1958).

[50] Fajardo Eastern Sugar Associates (A Trust), June 30, 1958 Annual Report 12-15 (1958).

[51] Central Violeta Sugar Co., S. A., September 30, 1958 Annual Report 6-9 (1958).

[52] Andes Copper Mining Co., 1958 Annual Report 6-7 (1959) (US Corp.).

[53] Badische Anilin- & Soda-Fabrik AG, Bericht über das Geschäftsjahr 1957 (appendix) (1958); Bochumer Verein für Gussstahlfabrikation AG, BOCHUM, Geschäftsbericht 1956-57, Bilanz der Gewerkschaft Christine und Gewinn- und Verlustrechnung, at 53 (1958); Bochumer Verein, Unser Werk 4, 59 (Engl. ed. 1956).

[54] Société française de constructions mécaniques anciens établissements CAIL, 1957 Annual Report 14, 16 (1958).

[55] S. A. Cockerill-Ougrée, 1957 Annual Report 21, appendices (1958).

[56] NV Koninklijke Nederlandse Vliegtuigenfabriek (Fokker), Verslag over 1957, at pp. 8, 9, 18, 20 (1958).

[57] Breda Ferroviaria SpA, 1957 Annual Report, appendix (1958); Montecatini Societa' Generale per l'Industria Mineraria e Chemica, Anonima, 1957 Annual Report, appendix (1958).

[58] Aciéries réunies de Burbach-Eich-Dudelange, SA, Rapports et bilan pour l'éxércice 1952, appendix (1953).

[59] See model financial statements, *post*, Table One.

[60] Société française de constructions mécaniques anciens établissements CAIL, *op. cit. supra*, n. 54, at 23.

vestment on the Continent would consider $2,000,000, including equity, long-term loan capital, and current financing, substantial.[61]

All amounts are given, where possible, in dollars, conversions into European currencies having been effected, where required, at exchange rates prevailing September 10, 1959.[62] Tax rates and laws are given as of April 30, 1958,[63] corrected to later dates when known.[64]

II

The description of the effects of the various fiscal systems upon the model firms requires consideration of the related tax burdens on the workers and the shareholders. The standard wage of $2000 which has been assumed is probably high by at least twenty per cent for most EEC countries,[65] but, while resulting in greater payroll tax liability (deductible, however, from gross profits in calculating taxable profits),[66] will yield the company corresponding advantages in attracting labor, in public relations, and in ability to cut wages where necessary and yet retain a competitive employing position, especially where the worker's own tax regime permits him to keep most of his gross remuneration, or where there are compensating social benefits. The relation between the general personal income tax liability of the shareholder and the subjection of his dividends to special taxation, either in his hands or in those of his company, is also important.

Taxes imposed at sales, measured by the gross selling price of the goods or services, range from a low of 2 per cent on each stage of transfer in Luxembourg (Umsatzsteuer)[67] to highs of 5 per cent in Belgium (taxe de transmission)[68] and the Netherlands,[69] and 20 per cent (but, in effect, on the final price to the consumer, only) in France (taxe sur la valeur ajoutée).[70] These levies do not apply to exports[71] and, in most EEC countries, the rates are modified, by reduction or increase, for transfers between particular participants in the distributive cycle, such as wholesalers, or for certain kinds of goods or services.[72] In Italy the usual rate is 3 per cent (Imposta generale sull'entrate)[73]; in Germany it is 4 per cent (Umsatzsteuer).[74] Whether of the cascade kind (Benelux, Italy, Germany) or of the "value-added" kind (France), these taxes bur-

61 Interview with Moreau, April, 1959.

62 N. Y. Times, September 11, 1959, p. 4, col. (city ed.).

63 FBI at ii.

64 Convenient materials in English containing recent information will be found in Walter and Hoffman, Summary of Essentials of Taxation in the Federal Republic of Germany (Fall, 1958); Gumpel, Reform of the German Income Tax Law, 37 Taxes 433 (1959); and Comité Franc-Dollar, Business Operations in France—A Guide for American Investors 28 (April, 1959).

65 NV Koninklijke Nederlandse Vliegtuigenfabriek, *supra* n. 56 at 9.

66 CGI, art. 38, for France.

67 FBI 110.

68 FBI 48, 50.

69 FBI 118.

70 CGI art. 273.

71 Reimbursement, by credit or refund, to the exporter for t.v.a. already paid, is provided for by Instruction No. 226 of August 15, 1955, implementing CGI arts. 262 ff.

72 France makes no distinction among participants, but certain goods and services are granted special rates. See, *e.g.*, CGI art. 262.

73 Pavia, Italian Taxes on Income and Investments, in American Management Association, Setting Up Operations under the Common Market at 48 (1958).

74 Bundesanzeiger-Verlags-GmbH, Bundesgesetzblatt 1951 I 791. Hereinafter cited BGBl.

den, not only the competitive position of the seller, but the consumer, to whom (by assumption) they may be shifted; and they should therefore be considered when estimating the value to the worker of his take-home pay. On the other hand, payroll-related taxes borne by the employer to support social insurance and benefits of various forms can, per capita, be considered as additional remuneration.[75] In the case of a firm employing two hundred persons at a flat wage of $2000 per person, such taxes would add charges, deductible from gross profits as noted above, of 1.2 per cent of the payroll in Luxembourg (Lohnsummensteuer),[76] 8 per cent in Germany (including trade association contributions),[77] 20 per cent in the Netherlands,[78] 35 per cent in Belgium,[79] and 50 per cent in France [80] and in Italy.[81] In Belgium and in France, the workers themselves bear substantial shares of the cost of such insurance.

Without taking into account the effect on him of indirect taxes, then, a worker paid $2000 in gross wages, assuming he were married and had one child and $5000 in property, could keep, after income, property, and social insurance taxes upon him, about $1830 in Luxembourg, $1742 in the Netherlands, $1659 in Belgium, $1650 in France,[82] $1607 in Germany, and $1498 in Italy. When the " invisible " benefit of the per capita employer's social insurance contribution is added, these figures become $1667 for Germany, $1854 for Luxembourg, $2142 for the Netherlands, $2233 for Belgium, $2498 for Italy, and $2650 for France. Do these differences reflect, or shape, differences in prevailing wage levels in the EEC? Although substantial interest has been shown in this problem,[83] studies of real wage levels, before

75 To the extent not shifted to the worker through lowered wages. In France the benefit to the worker is especially great because he is exempted from Taxe proportionelle (though not from Surtaxe progressive). CGI art. 1669.

76 FBI 110.

77 Rate given by Gumpel, *supra* n. 43.

78 FBI 119. Given for 1956 as 19% in Ohlin, Problèmes d'harmonisation et de coordination des politiques économiques et sociales, in Le marché commun et ses problèmes, Revue d'économie politique, No. 1, p. 271 (1958).

79 FBI 51-52. Given as 18% in Ohlin, *supra* n. 78, at 271.

80 FBI 84-85. Given as 30% in Ohlin, *supra* n. 78, at 271.

81 FBI 103. Given as 54% in Ohlin, *supra* n. 78, at 271.

82 The calculations are explained later in this article.

83 Relevant statistics can be found in Communauté européenne du charbon et de l'acier, Haute autorité, Salaire horaire dans les mines de charbon, in 7 Bulletin statistique, No. 2, pp. 62-64 (1959); UN Economic Commission for Europe, 1957 Economic Survey of Europe at A2-A5 (1958); Gilbert and associates, Comparative National Products and Price Levels—A Study of Western Europe and the United States, *passim* (1958); 6 International Confederation of Free Trade Unions Economic and Social Bulletin, No. 5, Real Wage Index, in Statistical Supplement I, Table 3 (unpaged, 1958); Comunauté européenne, Service des publications, Niveau de vie, in Statistiques de base de douze pays européens—Comparaison avec les Etats-Unis d'Amerique et l'Union des Républiques Socialistes Soviétiques 71-79 (1958); European Coal and Steel Community, High Authority, Real Income of Workers in the Community 8-11, 17-19 (1957); Consommation moyenne par habitant et par an, in Cépède, Lengelle, et du Page, Le marché commun 117 (1957); 3 International Confederation of Free Trade Unions Economic and Social Bulletin, No. 12, Statistical Supplement Table 7, Yearly Income of a Postman, and Table 8, Yearly Income of a Counter Clerk, showing for 1954 (?) mean weekly hours of work in each of the Six Countries, yearly income in national currencies, housing costs, taxes, social security costs, and net after the foregoing (1955); Gilbert and Kravis, An International Comparison of National Products and the Purchasing Power of Currencies, *passim* (1954); Council of Europe, Estimated National Incomes per Capita 1938, 1948-51, in dollars—current prices, in A Few Aspects of Population and Economy 59 (1952); UN Economic Commission for Europe, The National Income of European Countries 1938-1948, in 1958 Economic Survey of Europe 229-240 (1949); League of Nations, Statistical Yearbook 1940-41 at 178-195 (1941).

and after taxes, for similar occupations, seem not to have been made recently. In any event, as far as tax considerations alone are concerned, it would seem that a given French wage in the vicinity of the model figure could be cut by 30 per cent and still be as attractive to a freely circulating worker within the Common Market as the original wage would be if offered for employment in Germany, with intermediate discrepancies in the other countries. But, by the same token, raw labor costs to the business (making no adjustment for human or technological variations in productivity per man) would be less, by 30 per cent, in Germany, than in France, assuming workers were not free to migrate.[84]

The desirability to the worker of having a greater amount, absolutely and proportionally, freely disposable by him, though taken from a smaller total economic benefit, as against a greater total benefit, in large part segregated by the government for his future or contingent needs, is too subjective and political to be taken up here, though it is a problem raised by (or which caused) the fiscal treatment described. To the extent that " independence " in this limited sense is desired, Luxembourg and Germany seem attractive; to the extent that " security " is wanted, Italy and France have superior systems. If real wages are equal, workers desiring the additional social benefits of France and Italy will be attracted there from Germany and Luxembourg; those wishing a larger amount immediately spendable without restriction will head in the opposite direction, assuming they possess the legal freedom to do so. The contrast, in this dichotomy, between Luxembourg and its close economic partner, Belgium, seems especially noteworthy, since it follows from the above data that, while 26 per cent of a Belgian worker's total economic benefit appears as social insurance, only about 1.3 per cent of a 16 per cent smaller total benefit is so segregated from the Luxembourgois.

The question of what economic benefit the running up of large deductible amounts attributable to labor will bring to management or shareholders will vary with the business opportunities of the case and with the level of taxation on shareholders' dividends and on company profits. Low rates encourage savings on expenses; high rates would turn shareholders' attention toward having the government, in effect, subsidize operating costs, and, consequently, toward seeking benefits through economic expansion, where the profit margin would not justify expanding if the financing depended wholly upon private funds. Bearing intimately upon this is the degree to which dividend taxes are creditable against personal income taxes or to which dividend income is excludible from other taxable income, and what the tax bracket, in a progressive system, of the shareholding majority approximates. But an analysis should be based upon realistic assumptions as to the actual country of residence of the shareholders, and as to the distribution throughout the population of that country of available investment funds, and is therefore, also, left for treatment elsewhere.

The effects of the traditional forms of direct taxation, property and income taxes, are more obvious than are those of the transactions and payroll taxes. It is the former, accordingly, which have received attention in recent studies.[85] The

[84] But see European Coal and Steel Community, Obstacles à la mobilité des travailleurs et problèmes sociaux de réadaptation, *passim* (1956).

more dramatic aspects of rate and expense allowance have displaced any recent comparison of the scopes of " taxable profits " in the EEC countries, however, although exclusions, in some cases for special treatment, of capital gains,[86] distributed profits, investment income, and income imputed from property, cause important variations in the taxable bases to which the rates are applicable. The exemption of intercorporate dividends, where the recipient corporation owns a given percentage of the distributor, for example, should also be noted where applicable.[87]

Assuming that the narrowest common scope of profits subjected to corporate income tax has been determined, the Six will be found divided into two camps, one imposing flat rates, the other, progressive ones.

The impact of local and national taxes on property and on income attributable to, or imputed to, property, modify the impression of tax burden on net profits as defined in each country which might be gotten from the above listing, in some cases considerably. For corporations, taxes including a property element, and not included above, range from nothing in The Netherlands to a heavy German combination of .75 per cent or 1 per cent on total capital assets,[88] 1.4 per cent on buildings first occupied after March 31, 1924, situated in localities of between 25,000 and 1,000,000 population,[89] 2.0 per cent on business land, and more than 30 per cent on a locally-determined base including both " trade income " and " trade capital." [90] Further difficulty in comparing the effects of these taxes is introduced by the fact that they, like the taxes on profits, may vary in the definition of the taxable bases to which they apply.

III

The purpose of this investigation, a comparison of the burdens of taxation imposed upon domestic firms and their operations by the several Member States of the EEC while still " unharmonized," leads us, now that some general statements about the principal characteristics of the tax systems concerned have been made, to the point of actually subjecting the model firms to the levies they would normally encounter. It will suffice to describe the calculations made for one country, as an example, always remembering that each fiscal system has its own peculiarities of concept and computation. Let us choose France; reference is made throughout to Table I.

France

Taxes on A, C, and D are identical, except for some possible variation in the insignificant Patente and Contribution foncière, which are in the neighborhood of $1500 together. This is so because their payrolls, sales and supplies, and fixed charges attributable to sales have been assumed to be the same, and these are the determining factors for the French taxes considered.

85 Bille, *op. cit. supra* n. 41; for a general collection of foreign fiscal materials seeming to bear this out, see Szladits, A Bibliography on Foreign and Comparative Law 408-17, *passim* (1955). But some very pertinent studies on indirect taxation have been made: Laure, La réforme des impots sur le chiffre d'affaires, sur les transactions ou sur les ventes dans les differents pays de l'Europe occidentale en vue de leur unification, in 7th International Tax Congress, Cahiers de droit fiscal international at p. 7 (1953).

86 Comité Franc-Dollar, Business Operations in France—A Guide for American Investors at 31 (1959), for example.

87 E.g., in France: CGI art. 145.

88 BGBl 1954 I 137 (Vermögensteuer).

89 FBI 97.

90 BGBl 1957 I 1871, as amended on July 18, 1958 by BGBl 1958 I 473 (Gewerbesteuer).

TABLE I

FINANCIAL STATEMENTS OF THE MODEL FIRMS
(In thousands of dollars)

	A	B	C	D
BALANCE SHEETS, December 31, 1958				
Current assets:				
Cash and marketable securities	$ 100	$ 100	$ 100	$ 100
Accounts receivable	150	250	250	400
Materials	150	100	175	...
Inventory of finished goods	150	...	50	350
Work in progress	...	650	...	...
Fixed assets:				
Land	200	200	200	150
Plant	300	300	200	200
Fixed machinery	400	400	500	300
Patents, licenses, goodwill	50	...	25	...
Subsidiary	500	...	500	500
TOTAL ASSETS (liabilities)	$2,000	$2,000	$2,000	$2,000
Current liabilities:				
Accounts payable	$ 150	$ 150	$ 550	$ 150
Advances by customers	...	700	...	...
Fixed liabilities: long term debt:				
5% bonds	400	...	300	400
Fixed liabilities: miscellaneous:				
Reserves	75	75	75	75
Other equity:				
Earned surplus	375	75	75	375
Capital stock	1,000	1,000	1,000	1,000
INCOME STATEMENTS, 1958 fiscal year (varies with period covered by tax laws)				
Gross sales revenue	$2,040	$2,100	$2,040	$2,040
Miscellaneous revenue (inventory profits)	10	....	10	10
Subsidiary dividend	50	....	50	50
Wages	$ 400	$ 400	$ 400	$ 400
Supplies	1,000	1,000	1,000	1,000
Fixed costs ($70,000 financial)	200	200	200	200
Operating profit	$ 450	$ 500	$ 450	$ 450
Investment income	50	....	50	50

The mechanics of the Taxe sur la valeur ajoutée, levied at the sale of goods, will appear clearly from the following description. It is initially computed as 20 per cent [91] of the $2,050,000 gross sales receipts, or $410,000. Against this liability, however, may be credited the amount of this tax which suppliers of the model firms passed on to them, in the form of higher prices, in their purchases of supplies and equipment.[92] For the purpose of this calculation, it has been assumed that, of the $200,000 fixed charges relevant to the gross sales, $130,000 pertains to costs of wear, obsolescence, and similar expense on physical plant and machinery which were purchased subject to the t.v.a.[93] Twenty

[91] CGI art. 1614, as amended December 29, 1958 by Loi de finance pour 1959.

[92] CGI arts. 267, 273.

[93] See Table One. $70,000 of the "fixed costs"

per cent of $1,130,000, or $226,000 is, therefore, the amount creditable, leaving a net tax due the government of $184,000.

Labor-related taxes fall into three groups. The first, laid upon the total payroll, amounts to about 14 per cent (payroll tax, 5 per cent; apprenticeship tax, .4 per cent; paid holidays, 7 per cent to 8 per cent; and building contribution, 1 per cent).[94] The second, levied upon the first $1070 of wages per man, or on the first $214,000 of the payroll, equals 29.75 per cent (16.75 per cent family allowance contribution, 10 per cent social security contribution, and 3 per cent industrial injury insurance) of that figure.[95] Finally, a pension tax, assumed to come to about 5 per cent, is imposed on the remainder of each wage between the part assessable for social security contribution and about three times that, or, for our companies, on the $186,000 balance of the wage bill.[96] The first group of taxes totals $56,000; the second, $63,665; and the last, $9,300. The sum of these is $128,965.

When all the preceding taxes are deducted from taxable income, the subsidiary dividend excluded (as is proper under the intercorporate dividend credit), and the production expenses of labor, financial fixed charges, and net costs of physical plant and equipment (excluding t.v.a. paid at their purchase) are taken into account, profits subject to company income tax (Impot sur les sociétés) at 50 per cent reach $135,535, and the resulting tax is $67,768. The total of taxes to be paid comes to $382,233, and the reservable net is consequently $117,767, of which 78 per cent, or $91,700, is distributable, because of the 22 per cent dividend withholding tax. The ratio of reservable profits to gross profits after payment of t.v.a. ($117,767/$316,000) is 37.3 per cent; that of distributable profits to the same divisor is 29.1 per cent. Similarly, the ratios to the gross receipts, after expenses other than taxes and before accounting for t.v.a., are, respectively, 23.6 per cent and 18.3 per cent.

The computations for B vary from the above in that the t.v.a falls on the full $2,100,000 of gross revenue; but, since this revenue is assessed at only 61 per cent for building work,[97] the gross tax due is only $256,000, and the final liability is only $30,000 when the $226,000 of t.v.a. already paid on supplies and plant is credited. The amount of profit subject to the Impot sur les sociétés is thus increased, as it is by the absence of any subsidiary's dividend to be excluded. Taxable income then is determined to be $339,535, and the tax, $169,763, leaving an equal amount reservable, of which, again, 78 per cent, or $132,300, is payable to shareholders. The ratios are, to base including t.v.a., 34.0 per cent reserving and 26.5 per cent distributing, and, to base excluding t.v.a., 36.1 per cent and 28.2 per cent, respectively.

A French laborer would be surtaxed on his wage of $2000 less his social contributions (about 10 per cent: 6 per cent for social security and perhaps 4 per cent for other benefits) and allowed expenses (assumed here to equal another 10 per cent). Ordinary income tax (Taxe pro-

are shown as financial; the balance of the $200,000 is here referred to.

94 CGI, arts. 224, 227, 231, and 1669; 2 Code du Travail, art. 54.

95 Comité Franc-Dollar, Business Operations in France—A Guide for American Investors 34 n. 4 (1959).

96 FBI 84, 85.

97 FBI 83.

portionelle) does not reach him because his remuneration was subject to his employer's payroll tax.[98] The $1600 net income for surtax purposes is then assessed at 85 per cent, or $1360, and this is then divided by 2½ "parts" (since the taxpayer is married and has one child), yielding $544 per "part" which will be assumed to come within the lowest surtax bracket (10 per cent).[99] This rate is then applied to the full $1360, which gives a tax of $136, and this tax is increased by 10 per cent, or $14, because the total wage of $2000 exceeds a statutory limit of FFr. 600,000 ($1,215).[100] Thus the surtax totals $150, on the assumptions made, and, considering the worker's own social security payments ($200), he has $1650 remaining to spend and a per capita share of his employer's social contributions of about $1000.

IV

It is hoped that the figures thus compiled, which are summarized in Tables II and III following, will have indicative value for persons undertaking more detailed examinations of the problems of particular taxpayers. In most instances, opportunities will be found, which could not be gone into here, of benefiting from special rates and allowances.

The problem of the distribution, within a given country, of the total fiscal burden, between direct and indirect taxes, and the consequences of alternative solutions to this problem, for "harmonization," has also been left out of consideration, depending as it does upon acquaintance with the economics of manufacture and distribution of the particular countries of the Community.[101] A related problem, that of the

TABLE II

SOME IMPORTANT ELEMENTS OF THE E. E. C. TAX SYSTEMS

	Luxembourg	The Netherlands	Belgium	Germany	Italy	France
Turnover tax (per cent of gross receipts)	2%	5%	5%	6%	3%	20%[1]
Loss treatment:						
Carryover (years)	3	6	5	5	5	5
Carrybacks	...	1	...	...	...	...
Inventory valuation (F if LIFO is discouraged)	F	L	F	L	L	F
Dividend tax (credited against personal income tax, or absolute)	Cr	Cr	Abs	None	Abs	Abs
Disposable wages of $2,000 gross, assuming one child, wife, and $5,000 property	$1,830	$1,742	$1,659	$1,607	$1,498	$1,650
Worker's per capita share of employer's social contributions	$ 24	$ 400	$ 574	$ 160	$1,000	$1,000

[1] Equivalent of a single-stage levy on sale to customers; the other turnover taxes are multi-stage, cascade levies.

(Taken from data in FBI.)

[98] CGI, art. 1669.

[99] CGI, arts. 93, 94.

[100] Loi No. 56639, du 30 juin 1956.

[101] Cf. Kerlan, *op. cit.* n. 7, at 98-101, on this problem, and the following: Cosciani, Charges fiscales et prix de production dans les entreprises industrielles, in 5e Congrès international de droit financier et fiscal,

extent to which turnover taxes are "shifted," which led to two sets of computations of comparative percentages in this study, has been presented, on the assumption that either full shifting or complete absence of shifting occurs. Where the degree of shifting falls between these limits, or not all firms being compared can shift equally well, the variation from the positions shown on the accompanying tables may be as much as ten percentage points of gross profit, as inspection of Table III will make clear. Since disposable profits, as a percentage of gross profit, could cover a forty-point range (from Luxembourg C's 57.8 per cent when reserving, assuming turnover tax to have been completely shifted, to France A's, C's, and D's 18.3 per cent when distributing, assuming complete absorption of the t.v.a.), a ten-point variation is twenty-five per cent of the possible spectrum, giving great importance to this problem for purposes of business decisions to locate within a given nation. France and Germany, countries where this study showed such taxes to be especially large in relation to the total tax bill of a firm, are especially affected in this respect by the line of analysis followed; Luxembourg and Italy, least.

In general, then, it appears from the data gathered that Luxembourg is the best country in which to establish any of the firms described, for the purposes of distributing or retaining, after taxes, maximal percentages of earnings. France, and after France, Italy, make the poorest showings, though the subsidiaryless France B (the construction firm, which also gains by a special rate of t.v.a.) does substantially better than its Italian counterpart. At some points, little difference among countries is to be found: Germany and the Netherlands are not far apart, and Belgium and Italy, a little lower down on the scales, are usually together as to net dividends available per given gross earnings. Germany's attractive low rate on income to be distributed gives it excellent competitive standings from that viewpoint; but its heavy property, local, and reserved income taxes seem to make it an undesirable country in which to conduct a business which intended to finance its expansion from its profits. (However, any applicable expense allowances would have to be taken into account here to confirm this.) Must German companies borrow, or attract new capital, to grow? or do they distribute, only to have their shareholders reinvest in them?

Without change in the present national tax structures, then, as the impact of internal fiscal provisions makes itself felt throughout the Community, with the progressive relaxation of barriers to the free flow of capital and labor, certain economic movements may be expected to compensate for the inequalities which exist. Capital will be induced away from France and Italy, and toward the Benelux countries and Germany. Meanwhile, as noted in Part II, many workers, desiring additional social benefits, may migrate to Italy and France. A movement of capital in one direction and labor in the opposite cannot, of course, continue long; but its self-correcting tendency may not be sufficient provision for the human dislocation meanwhile taking place. Moreover, the EEC concept of free flow for goods, persons, services, and capital may exclude the thought that such movements should be due to artificial political decisions about taxation, instead of being responses to

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20 Cahiers de droit fiscal international 86 (1952); Desmyttère, Incidence des charges fiscales et parafiscales sur les coûts de production, in 6 *id.*, 21 Cahiers de droit fiscal international 125 (1952).

TABLE III

SUMMARY OF COMPARATIVE BURDENS ON TAXABLE PROFITS

	Luxembourg	The Netherlands	Belgium	Germany	Italy	France
Per cent of profits before accounting for turnover tax due, available for:						
Reserves						
A	52.4%	38.4%	39.8%	30.6%	27.6%	23.6%
B	48.2	34.8	39.7	29.6	24.4	34.0
C	52.9	38.4	39.8	30.9	27.5	23.6
D	56.2	47.6	40.2	30.0	27.6	23.6
Dividends						
A	44.6	32.6	26.4	43.8	27.6	18.3
B	41.0	29.6	27.8	45.8	24.4	26.5
C	44.9	32.6	26.4	45.9	27.5	18.3
D	47.7	40.4	27.0	44.2	27.6	18.3
Per cent of profits after excluding turnover tax due, available for:						
Reserves						
A	57.1	48.3	50.1	36.6	30.8	37.3
B	52.8	41.9	50.3	35.0	27.9	36.1
C	57.8	48.3	50.1	37.0	31.4	37.3
D	57.4	49.0	50.6	35.9	30.8	37.3
Dividends						
A	48.5	41.0	33.2	52.5	30.8	29.1
B	44.8	35.6	35.2	54.5	27.9	28.2
C	49.1	41.0	33.2	55.0	31.4	29.1
D	48.8	41.0	34.0	52.5	30.8	29.1

real economic opportunities which may exist and impel motion in quite different ways.

In excluding study of the effects upon the picture drawn here of the tax treaties which link the EEC countries, and of the extent to which the various national turnover taxes actually burden trade, this paper observed a necessary limit. It is hoped, however, that such a study, together with a consideration of the relevant market and geographic factors,[102] will provide lessons in intergovernmental fiscal cooperation, not only for EEC, but for other areas of the world which may find the European example worthy of parallel.[103]

[102] Some materials which may be found useful in this connection include: European Economic Community, Rapport sur la situation économique de la communauté (5 vols., 1958); Delperée, Les charges salariales et sociales et le marché commun, in Les problèmes de l'Europe, No. 1, Troisième trimestre 1958, at p. 39; Harris, International and Interregional Economics, *passim* (1957); van der Goes van Naters, La développement de l'intégration économique de l'Europe 16, 19 (1955); Philip, L'Europe unie et sa place dans l'économie internationale, *passim* (1953); and Sliwka, Les mouvements internationaux de capitaux et la reconstruction économique de l'Europe, *passim* (1948). Helpful legal sources not previously mentioned include Douglas, Olds, and Tschierschky, Etude sur la régime juridique des ententes industrielles, in 2 League of Nations, Questions economiques et financières, *passim* (1950); Council of Europe, European Companies, *passim* (1952); and Collection Jupiter, Recueils pratiques du droit des affaires dans les pays du marché commun (2 vols.), *passim* (1958; current looseleaf service).

[103] See, *e.g.*, Pan American Union, Agreement Establishing the Inter-American Development Bank, Art. 1 §§. 1-2, at p. 17 (1959).

SELECTING INCOME TAX RETURNS FOR AUDIT *

JOSEPH H. MURPHY †

I AM sure that all of you recognize the fundamental importance of a sound audit program designed to insure an equitable application of the tax law. It is a basic canon of taxation that each person should be asked to pay neither more nor less than his rightful share of the cost of government. To the extent that most tax evasion occurs through improper exemption and deduction claims, the honest taxpayer is being penalized by disproportionate contributions to the public till.

At first blush, it might appear that the safest way to make sure all taxpayers accurately report their taxes is to check each return carefully and follow up on any item which suggests further investigation. However, this approach is not only impossible in the light of our limited resources but impractical from a financial standpoint, since most taxpayers are thoroughly honest and since countless cases arise where the cost of conducting the audit exceeds the expected return.

The basic problem facing the tax administrator is the determination of that allocation of available resources which will maximize the yield from the audit program in relation to operating costs. At the same time, the desire to use our personnel and facilities economically must not conflict with our basic responsibility for eliminating, or at least minimizing, the more glaring areas of tax evasion.

Our previous audit system was essentially extensive in nature wth virtually no selectivity. Since most taxpayers are honest and fully aware of their tax responsibilities, locating those returns which required audit was like hunting for " the needle in the haystack." The result was an extremely small yield per return examined.

Furthermore, the growth in number of returns filed has been significant for each year in the postwar period. In the calendar year 1946, for example, 2.7 million tax returns were filed. Last year, 5.3 million were filed. This growth of virtually 100 per cent was reflected in our audit work load, but was not accompanied by a commensurate increase in the audit staff. As a result, the audit program was faced with enormous and increasing backlogs. Furthermore, there was some evidence that the audits tended to become superficial because less time was available for doing the job properly.

Of perhaps even greater import, this growing lag in the assignment of returns to the audit process had become so serious that we were dangerously close to the three-year statute of limitations. Since it is evident that no administrative agency can tolerate a system which does not provide for effective enforcement well within the legal time limit, a crisis had been reached.

In previous years, this problem was solved simply by adding more auditors.

* Address delivered May 21, 1959 before the Sixth Annual Conference on Government Statistics, Albany Chapter of the American Statistical Association.

† President of the New York State Tax Commission.

Governor Rockefeller, however, holds to the philosophy that maximum economy in State government can be achieved through modern administrative practices and techniques. In this case it meant the development of a more realistic basis of selecting cases for audit to reduce the number of cases to a manageable level and yet increase our audit productivity. Our Research Bureau felt that this objective could be attained through the use of criteria reflecting inherent marital and income differences among taxpayers.

For the last twelve years, our Research and Statistics Bureau has conducted annual surveys of personal income-tax returns. These surveys use stratified random samples based on size of tax. Data on sources of income (i.e. wages, interest and dividends, business or professional income, rents and royalties) are collected. Deductions claimed are shown by each major type and include such items as mortgage interest, real-estate taxes, contributions, life insurance, medical expenses and child care. Data are classified according to tax payments, both normal and capital gains, residence and marital status of the taxpayer.

Analysis of these data revealed a steadily rising ratio of deductions claimed to gross income reported. Some increase was expected because of rising medical, insurance and other costs. But our data indicated a growth in excess of such expectations. For instance, in 1947, deductions comprised only 11.9 per cent of total income reported. By 1956, this figure had risen to 14.69 per cent.

In view of this increase, it was decided to make a qualitative evaluation of deductions claimed in the light of established " normal " behavior. The use of " norms " was to be the pivot around which the entire audit selection procedure would revolve. Those returns would be eliminated as an audit possibility on which the taxpayer's claim for each itemized deduction fell below the predetermined norm. On the other hand, if the taxpayer exceeded any of the norms, his return would be selected for audit.

At this point, it should be said that, with the exception of those cases where a statutory limitation (such as the 15 per cent limit for contributions) has been improperly applied, the mere exceeding of a norm does not imply illegal action on the taxpayer's part. Just as the psychologist says that there is no such thing as a " normal " behavior pattern, we expect many taxpayers to sustain legitimate expenses in excess of normal levels.

The fundamental purpose of norms can only be to " separate the wheat from the chaff " and isolate areas of relatively more productive audit. In this respect, we have found a high correlation between higher-than-normal claims for the deduction items for which norms are established, and assessments on items for which there are no norms. As one of the men in the Department told our Research Director, Dr. Chester Pond, " How lucky can you be? You select a return for one reason and end up assessing the taxpayer for something else entirely! " Call it what you will but this is a basic fact distilled from our findings in this and other areas of tax research.

What is a " norm? " If John Smith earned $5,000 last year and gave $50 to charity, we would certainly not accuse him of an excessive deduction. But, if he claimed an allowance of $500, we would conclude either that he was unusally charitable or that he was mini-

mizing his tax liability. Obviously, our "norm" for contributions is neither $50 nor $500 but some reasonable level between them. What we looked for was that point which a person in a given marital status with a given income would not likely exceed. Although I am not at liberty to tell you what this reasonable level is, let us see just how the norms were determined and the philosophy upon which they are based.

I have already referred to the annual personal income-tax surveys conducted by the Research and Statistics Bureau. The latest analysis, based on returns filed in 1957 for the 1956 income year, included the usual information on sources of income and residence, but refined the data on taxpayer's marital status and deduction claims. Prior to this study, limited facilities had confined the marital-status code to *single, married* and *head of family* so that we had been able to study only one (or at most, two) major deduction items. By going to two punched cards per case for the 1956 survey, our research staff was able to expand the marital-status code to identify married taxpayers filing joint returns and married taxpayers filing separately. It was further possible to include separate treatment of each major deduction item.

The Bureau felt that with this expansion of coverage it was in an advantageous position to develop norms of a sufficiently qualitative character to reflect the changes in taxpayer deduction patterns accruing for different income levels and marital categories. Such items as contributions, mortgage interest, and real-estate taxes tend to correlate fairly closely with income level and are definitely affected by the marital status of the taxpayer. It is unrealistic to expect a single man earning $3,000 to contribute as much to charity as an equally unencumbered individual with an income of $10,000. The contributions of a single person earning $10,000 will not be comparable to those of a married man with children at the same income level. Home ownership is more of a necessity for the married man than for single persons. Married couples with children can be expected to report greater medical expenditures than childless couples or single people of comparable income status. So sensitively attuned are these deduction patterns that significant differences can even be found between married taxpayers filing joint returns (where, in many instances, only one income is available to the family unit) and married persons filing separately from their gainfully employed spouses.

Another feature of this whole concept of selective norms is the fact that our allowable deductions include a set of factors which cannot be expected to approximate the same dollar amount for any given case. A widower earning $5,500 a year, for example, and supporting two small children, could very reasonably be expected to take full advantage of the $800 child care allowance. A similar deduction for medical expenses would be possible but would be unusual. On the other hand, a deduction of $800 for contributions, representing virtually the maximum allowance, would strongly suggest tax minimization. The point is that, for any given set of circumstances, no single dollar criterion can serve as an effective filter through which the potentially productive cases will pass while leaving the others behind.

With statistical information supporting these observations of taxpayer be-

havior, the Bureau derived a set of norms for each appropriate gross-income class according to these marital-status categories: single taxpayers, married taxpayers filing separate returns, and married taxpayers filing joint returns.

The best norms in the world would not help us very much if the Department was not able to handle the volume of returns selected by the process. Department administrators preceded this statistical evaluation with a detailed study of potential audit capabilities and estimated the number of cases to be audited. The Research Bureau then designed criteria for attaining this goal. We have intentionally selected more returns for audit during this first year than may be practical in subsequent years, so that enough cases may be available for continued research. The figures upon which our norms are based were compiled before audit and therefore included many questionable deduction claims later adjusted in the audit process.

The development of norms for each allowable deduction of major importance has given us an effective tool for handling the most pressing audit problems. However, there are other areas deserving consideration under this approach.

For example, an enterprising taxpayer could build up a sizable aggregate deduction figure by skillfully reporting individual deduction items at a level which, taken by themselves, would not appear to be excessive. Conceivably, these returns could escape our " audit screen " of individual norms and thus be rejected for audit, though potentially productive. We have protected against this by establishing reasonable criteria (according to marital status and income level) for the ratio of net income after deductions to gross income. All returns registering a ratio below the appropriate " norm " are forwarded to our auditing staff. Actually, this is perhaps the best test of all.

Returns with non-wage income have always been a lucrative area for concentrated audit effort and they are liberally represented in our present audit work load through the use of realistic audit criteria. Returns with capital-gains-tax payments, if the capital-gains tax exceeds a certain level, are also subjected to a complete audit.

We think this concept of applying statistical norms to our income-tax return is a sound approach which can produce an audit-selection system of maximum effectiveness at any predetermined cost level. This is not to say that acceptance of this idea came easily within the Department. Any new approach, especially one which involves mechanization, is bound to meet with some resistance. Fear of job loss or of demotion in status is a natural consequence of such action. Confronted with a radically different approach to audit selection, our auditors and income-tax administrators were at first reluctant to give up their long-cherished idea that an *extensive audit* was the *best audit*.

There was also the feeling that this was to be a " machine " audit, thus removing the need for any sizable audit staff. Allaying these fears was not easy. Our Research Bureau conducted pilot tests on small numbers of returns and prepared graphs and tables showing that this method offered lucrative opportunities for solving the problems of work loads and audit superficiality that were then plaguing the Department's top management.

The Bureau was further able to con-

vince all concerned that, far from being a "machine" audit, this procedure was designed to increase audit productivity by making available to the auditors those returns which offered greater promise of larger assessments. Instead of reducing the prestige of the auditor, the proposed system provides him with a chance to apply his skills in greater depth and broader perspective, thus enhancing his status and making his work more productive. Let me make it perfectly clear—we still have a tremendous job to do that requires the services of these highly trained people.

We realized that norms by themselves are meaningless. We needed a vehicle by which this theoretical concept of norms could be translated into a practical tool. A manual approach to the determination of audit cases was impractical, since it would entail the prohibitive task of comparing each appropriate deduction or income item on each return with the established norms. Conventional machine-accounting equipment would relieve audit personnel of this burden of screening each return but would introduce many other problems.

Since we would be interested in testing the validity of each tax return against many norms, and since it is not expected that a taxpayer would be rejected under every such criterion, the selection of audit cases on standard punched-card equipment would involve one of two basic techniques. For each return, one punched card would be prepared with data on each of the items subject to a "norm" comparison. Separate sorting on each field of information would then be required for individual comparisons with the norms. This would entail far more sorting than would be reasonable for this type of project. The only way to avoid this volume would be by preparing a set of punched cards for each case, with one card for each item to be tested. Obviously, this approach is subject to the same criticism as the other.

Our investigations indicated that the solution to our problem called for use of an electronic computer. Without going into detail, it is sufficient to note that the IBM 650 contains a memory unit which provides for the simultaneous storage of many pieces of information and for the concurrent application of many test conditions. With the IBM 650, we are able to analyze each tax return, determine whether or not it should be audited and, for those cases requiring audit, prepare punched cards which serve to identify the item or items needing scrutiny. The cost of installing an electronic computer and paying the monthly rental fees are such that we would not have considered it if we did not have other mass processing jobs to justify this expenditure. About 12 per cent of the computer's weekly capacity is required. The remaining 88 per cent of machine capacity is used for other accounting and research operations.

Turning now to the actual procedure, all tax returns available for audit are first routed to the Income Tax Bureau's key-punching staff for the preparation of a special card containing a code for the marital status of the taxpayer and data on gross income and on each of the items to which a norm is to be applied. As the information on the card is read into the 650, the computer screens each item and compares it with the appropriate norm.

To illustrate, let us suppose that a norm of $100 is being used for all deduction items, with an 88 per cent ratio

of net income to gross income, and that we are testing three taxpayers against these criteria. Taxpayer A has claimed modest deductions throughout, all less than $100, and has reported net income well over 90 per cent of his total earnings. Since this taxpayer has passed all of our criteria, the punched card representing his return will be rejected by the 650 as unproductive of further analysis. Taxpayer B has also reported deductions of less than $100 for each item, but each of his claims is sufficiently close to the $100 norm that his ratio of net income to gross income is only 87 per cent. In his case, the computer will prepare an output card calling the auditor's attention to this feature and alerting him to the need for a general review of all deduction items on this return. Taxpayer C, while maintaining a modest level of deductions for all other items, has claimed an expenditure of $120 for contributions. Again, an output card from the 650 will acquaint the auditor with this situation.

Although these examples refer only to deduction items, it should be understood that norms relating to non-wage income are applied in exactly the same fashion. The cards are then matched with the original returns, which are first sent to the Computing Section for a clerical check on arithmetical errors and subsequently forwarded to the Audit Section for action along the lines suggested by the audit screen.

Finally, the computer calculates the correct tax liability and earmarks all incorrect cases for automatic assessment.

The installation of this new audit selection procedure constitutes a radical departure from the previous system which was in operation for so many years. Therefore, we are most anxious to learn its effectiveness. We have already conducted several tests designed to answer one fundamental question: How much potential revenue will be lost through the rejection of cases by the computer which would have been assessed under the previous system? If our norms were not properly exercising their selective function, many productive cases would slip through our screen. Results from fairly comprehensive test audits are encouraging in that to date we have found no appreciable revenue loss from this group of returns. This negligible loss is more than offset by increased audit productivity from the selected cases.

The tests which I have just discussed reveal clearly that our norms are selective enough to prevent the rejection of any large volume of productive returns. We must now turn our attention to an evaluation of those norms with a view towards selecting even fewer cases while preserving our assessment level. This work is now in process. A final appraisal must await the completion of the audit of 1957 returns, since all of the work done on those returns will be on the new basis. At that time, we hope that an analysis of the ratio of collections to assessments, utilizing special computer programs, will be most illuminating as a means of instituting needed refinements.

As for assessments, we expect that many of the taxpayers against whom assessments have been issued will provide satisfactory explanations of their claims. The extent to which our norms select cases on which no collection can be made on an assessment determines the ratio of collections to assessments. Through a detailed study of the reasons for this ratio we hope we can improve

the norms. This improvement will also reduce correspondence with a clientele which already views us with skepticism and understandable lack of enthusiasm.

In closing, let me emphasize that with the application of electronic computers to audit selection, we will be able to study intensively both the personal income-tax statistics compiled by our research staff and the actual audit experience emanating from the computer-selection procedure. From these analyses, we can further refine our approach to the problems of audit selection, develop more meaningful relationships between the various items on the tax return, and provide the auditors with better acceptance levels for isolating cases of potential audit value. The foreseeable scope of such research is circumscribed only by the ever-present element of cost versus return. We fully realize that, so far, we have merely scratched the surface. In the areas of capital-gains taxes and non-wage income much work remains to be done.

Intensive analyses of such unexplored territories as gross profit ratios and the relative behavior of such business-activity indicators as gross receipts, cost of goods sold, inventories and net profit hold forth the rich promise of a business audit based on much sharper criteria than we have possessed heretofore. Just how far-reaching our research can become remains for the future to determine, but regardless of scope, we *must* have an audit program that will ensure maximum equity to every taxpayer, so that the honest individual can rest assured that he is paying no more than his share of the cost of our government.

MASSACHUSETTS PERSONAL INCOME TAX REVISION

EDWARD K. SMITH *

I. INTRODUCTION

SINCE its enactment in 1916 the Massachusetts personal-income tax has increased yields nearly a thousand per cent. It was first designed to tax intangibles which were escaping taxation under the old general property tax and until the post-World War II years it was mainly a tax upon interest and dividend income, around 70 per cent of revenues being from these sources. Since shortly after the war, the tax has become much more general in its impact, for with changes in the basic rates and given the large growth in earned income the tax has become a mass tax, deriving the largest proportion of its revenues from wages, salary and business income.

While there have been minor revisions in the base of the tax since its inception in 1916, no major revisions have taken place. The growth in yield to over $112 million in 1958 has been a result of rate changes and population and income growth. Historically, a $200 increase in per capita income has increased its yield by almost $15 million and a population increase of 200,000 would add another $25 million. Increased yields by the surtax and temporary tax devices have played an increasingly important role. In 1957 the state share of the total yield was about 43 per cent. The cities and towns have been receiving a decreasing share of a growing tax total.

For a variety of reasons, both in law and in administration, the tax has historically impinged mainly on higher income earners. The range of potentially taxable income is vastly greater than that which is actually tapped for revenue under the law. The very generous exemptions and deductions of the Massachusetts tax along with significant exclusions of income from the tax base narrow the tax base excessively. The great mass of taxpayers have a very low tax liability as a result.

Several of the revisions suggested here have been made by some special commissions and other study groups in the past. Indeed, tax and/or expenditure commissions were in existence for 30 of the 41 years since the personal income tax began in 1916. Since that time fourteen new taxes have been imposed but only two were removed. There were 26 increases in rates on new and existing taxes and three major increases in tax bases. During all this period taxes were lowered only three times. New taxes seem to be preferred over improving old ones. The system has grown in a haphazard and pragmatic fashion. It is now proposed to continue this scheme of things by the imposition of a wholly new tax, the sales tax, despite the fact that many special commissions have pointed out the need and usefulness of improving the personal-income tax.

Today Massachusetts ranks as one of the highest states in per capita state and

* Assistant Professor of Economics at Boston College.

local taxes, and as one of the highest in the proportion of state and local revenues obtained from property taxes. At the same time, on the state level, it is in the front ranks in obtaining revenue from income taxes. It follows from this that as an " income tax " state it will either have to improve its income taxes and increase state aid to relieve local property tax burdens, or it will have to turn to other taxes, notably sales taxes, to carry the burden. Increases in its corporate income taxes are unwise, for Massachusetts now has the highest state corporation taxes in the nation. We must then turn to the personal-income tax as the major source, or to a general sales tax.

Revision of the tax may take essentially two forms: 1) a revision of the structure of rates and 2) a revision of the base of the tax. A third form, which may or may not involve statutory changes, involves revision of the administration of the tax, which is a vital ingredient in the attainment of equity and the distribution of burdens as " intended " by the statutes. We may emphasize that whatever changes in law may be made, they will only be fruitful insofar as they are properly enforced.

Revision may be undertaken with two major ends in mind. One is to increase or decrease the yields of the tax and the other is to improve the equity with which the tax burden is distributed, the latter including consideration of the economic effects of the tax on growth and stability of the economy involved. The revision of a given tax cannot be undertaken *in vacuo*, for the totality of the tax system, federal, state, and local, should be a major force shaping its construction. This is a pertinent consideration, not only for the equity of the system as a whole, but also for administrative reasons. Numerous examples may be cited, e.g., federal regulations on depreciation, income splitting, capital gains, and use of the pension funds, that can affect state tax revenues in ways now unknown. Again, the progressivity of parts of the federal system may be offset by the regressivity of state and local systems, but as to just how much there is great debate.

Tax revision undertaken on the state level merely to conform to the cannons implied by progressivity is unlikely, no matter how regressive in nature the state-local system might be. The very high marginal rates of the federal personal-income tax provide a vigorous defense for the status-quo on the state-local level. This defense may not always be factual or rational but it is usually effective.

II. CLOSING LOOPHOLES AND REDUCING TAX BASE EROSION

The most obvious measures to take in seeking additional revenues are to close present loopholes in the income tax and to deter erosion of the tax base. Some tax loopholes existing in the past in Massachusetts, such as the exemption from income of the dividends of domestic corporations and gains from the sales of real property have been closed. The first came in the mid-thirties and was made permanent in 1945 and the latter was introduced in 1954. Since the reorganization of the Department of Corporations and Taxation in 1953 many changes in detailed provisions of the statutes have been made and a fairly steady stream of bills have been poured into the legislative hopper. However, major changes have not been undertaken, though of course some of the

changes were very important to certain taxpayers, as is usual with minor detail revisions.[1] We need not be concerned with these minor changes here. It is unfortunate, however, that their revenue effects are unknown. Most of them are being made either to conform with federal statutes and rulings or to clarify the Massachusetts law and remove what often had been a determination by administrative decision solely by the Tax Commissioner in the days before the Department's reorganization. Some of them are in the nature of loophole closing, though minor, and some are designed to improve equity. But some may create new loopholes, e.g., the exemption from income of stock dividends paid in stock of the issuing company, not solely in new stock as previously.[2]

The major devices by which income may avoid taxation under the Massachusetts statute are: (1) income received by partnerships, associations and trusts with transferable shares (the Massachusetts Trust), (2) income from real estate, (3) interest income from mortgages, and bonds or notes secured by mortgages, (4) savings bank dividends, interest on share savings accounts in co-operative banks, credit unions, savings and loan associations, and federal savings and loan associations located in the Commonwealth and (5) interest received on obligations of the United States, its states or territories, the Commonwealth of Massachusetts and any of its agencies or sub-divisions.

We may comment on each of these in turn. It has been stated that a major aim of the income-tax statute is to avoid taxing what, in one way or another, is already taxed within the Commonwealth. Thus the major exclusions deal with income related to real estate, for real property is taxed under the property tax. However, a major loophole is present, for a very large part of income earned via real-state operations is excluded, income which is taxed generally as business income under federal law. Either this income is directly excluded, as in rents, or is excluded by way of the " Massachusetts Trust," where the trust files an agreement with the Tax Commissioner to pay income taxes. In the latter case the greatest number of trusts deal in real estate and thereby have most or all of their income excluded, and the dividends from such trusts are then not taxable to the shareholders.

The Massachusetts trust is basically the common-law joint-stock company to which has been added the common-law trust. It is not taxable under Massachusetts corporate-income or excise taxes because it is exercising a common-law privilege and not one conferred by the state.

At present the Department of Corporations and Taxation is undertaking a study of the Massachusetts trusts, under powers granted it by the General Court. Little is known about these trusts except the number of them filing agreements with the Tax Commissioner and the general area of their operations. The results of this study should be enlightening and for the first time we should be able to estimate closely the income derived from their activities.

It has long been recognized that the tax privileges granted by the trust device are inequitable and constitute a significant loophole by which owners of

[1] There were ten such revisions enacted in the 1957 legislative session. See Commonwealth of Massachusetts, Department of Corporations and Taxation, *Technical Discussion of 1957 Tax Legislation*, Boston, 1957.

[2] St. 1957 c. 445 amending Ch. 62, Sec. 1 (6).

large apartment houses, hotels, office buildings, stores, etc., escape the taxation which corporations engaged in manufacturing activities bear. The privileges granted real estate were pointed out as in need of correction by a legislative commission as early as 1924 and have been condemned as inequitable by successive commissions since then. The Special Commission of 1948 was vigorous in its argument for doing away with the loophole and so also is the recent study completed for the Massachusetts chapter of the Americans for Democratic Action.[3]

The exemption of rental income and interest income from mortgages, either alone or via the Massachusetts-trust device, cannot be condoned under the double-tax argument, for it is only the net income which ought to be taxed and property taxes are a deductible expense in computing net income, as in federal income taxation. Furthermore, it is not the small operator who benefits from these exclusions but rather the large real-estate holders and mortgage investors. Gains are taxable (as business income) if they arise from property sales entered into for profit, except for the sale of property which is the residence of the seller. This loophole was only firmly closed in 1954.

That the double-taxation injunction creates inequities is aptly illustrated also in Massachusetts taxation of savings banks, where a prominent deduction from the tax base is the investments in mortgages in Massachusetts, one of the many large deductions serving to eliminate most if not all of the tax liability of Massachusetts savings banks under the savings-bank tax.[4] The Special Commission report concluded that the savings-bank tax " is not an adequate substitute for the taxation of the interest from deposits in savings banks under the personal income tax " and that " the avoidance of double taxation has resulted in no taxation."[5] In 1952, for example, 77 savings banks out of 138 in the Commonwealth, most of them very large, had exempt deposits exceeding total average deposits, such that no taxes were paid, due to the peculiarities of the law in classifying " deposits " to be included in the base of the tax.[6] It would appear only fair then to either completely revise the law taxing savings banks, which as it works out bears no relation to income, or to tax the dividends of the depositors under the personal income tax. Inasmuch as co-operative banks, and state and federal savings and loan institutions pay no state income or excise taxes for the privilege of doing business in the Commonwealth, it would be best to do away with the taxation of savings banks as such in order to put them on the same footing as their counterparts and to tax the dividends (or their equivalents) under the personal income tax.[7]

Administrative considerations may dictate that a minimum of perhaps five dollars in savings dividends per taxpayer be exempted from income taxation in order to avoid the complications which

[3] Arnold M. Soloway, *A Balanced Fiscal Program for Massachusetts*, Massachusetts Chapter, Americans for Democratic Action (Cambridge, 1956) p. 25.

[4] See Commonwealth of Massachusetts, Special Commission on Taxation, *The Taxation of Banks and Banking Institutions*, Part X, House 2626 (Boston, 1954) p. 53.

[5] *Ibid.*, p. 57.

[6] *Ibid.*, p. 59.

[7] It should be noted that the federal exemptions of savings banks from taxation was ended by the Revenue Act of 1951 and that interest on deposits is taxable under the federal personal income tax.

would ensue to a very large number of taxpayers now using the short-form return. The proposed change would simplify the tax laws of the Commonwealth by eliminating an ineffective tax, placing savings banks and savings departments of commercial banks on the same footings as other savings institutions, and bringing back into the tax base a large segment of income now escaping taxation altogether.

We are then left with the problem of taxing interest received on government obligations, federal, state and local. We can only suggest that tax-exempt issues tend to favor upper-income groups but there is something to be said for the lower interest rates resulting for the states and localities. However, the distortions which take place in investment markets because of exempt issues and the uses which are made of some tax-exempt issues, e.g., building manufacturing plants for leasing to private businesses, are arguments against their continuation. The constitutional issues involved are important and may block any reform in this direction. Moreover, the states and the federal government would have to act together to make the change workable. At the moment, this loophole does not appear to be amenable to change.

There remains a general problem in closing these loopholes and that is to prevent any further incursions on the tax base by creating new ones. If we do not close the major loopholes which now exist, we must at the very least prevent new ones from creeping into the structure of the personal-income tax, as they have on the federal level. The erosion of the federal tax base is well known.[8] Such devices as differentiating short and long-term gains, a device not available under the Massachusetts tax, remove huge sums from the tax base. If in their attempt to make the Massachusetts income tax accord more closely to the federal income tax, for commendable reasons such as administrative efficiency or whatever, the administrators and legislators in Massachusetts bring into the Massachusetts law many of the tax loopholes and preferential treatment taxpayers may obtain under federal law, then a grave disservice will have been done to the majority of Massachusetts taxpayers and to the Massachusetts fiscal system. At the low rates prevailing under the state income tax there is little excuse in narrowing the tax base. The argument of excessive taxation of infrequent or one-time income at high marginal rates which is advanced for capital gains treatment simply does not hold in a proportional rate structure. Nor do many of the other arguments advanced for income exclusions hold in the rate structures typical of most state income taxes.

The erosion of the base stems from a desire to shift the incidence of the tax and it is unfortunate that at the state income-tax level we do not have the kind of data necessary to evaluate the effects of the many technical changes demanded by the spokesmen for special interests. Given the revenue demands now being made upon the Commonwealth, there is every reason to deter incursions upon the tax base. Widening, not narrowing, is called for. This does not, of course, preclude the removal of obvious inequities in the tax.

[8] See U. S. Congress, Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability*, Joint Committee Print, 79th Cong., 1st Sess. (Washington, November 1955) Section VI, pp. 251-311; and Ruttenberg, Stanley H., "Erosions in the Tax Structure" and Kreps, T. J., "Taxes and Economic Productivity," *Proceedings*, National Tax Association (Sacramento, 1957) pp. 15-35.

III. BROADENING THE TAX BASE: REVISION OF DEDUCTIONS AND EXEMPTIONS

In addition to the exclusions from gross income which are the basis for some of the loopholes which we have discussed above, the exemptions and deductions available in the Massachusetts law narrow the taxable base further. Assuming the need for increasing revenue, it then becomes necessary to widen the base of the tax, for income growth and administrative improvements alone cannot be expected to meet the increasing revenue needs of the state in the future.

In general, deductions are a result of attempting to bring equal treatment to equals or simply of the tradition of avoiding double taxation. They may, of course, proliferate to an extent unimagined or unintended by the original act. To some extent this has taken place in Massachusetts. A recent example is the addition of a deduction for medical expenses.

We must remember that in arriving at net income derived from business or professions, the ordinary and necessary expenses of earning that income are deductible. We are not concerned with these " deductions " except to note that recently a wider application of the notion of " net income " has been introduced in the administration of the law by way of emulating federal definitions and procedures. A regulation entitled " Deductions and Credits " has also been issued to clarify the law and help in taxpayer compliance. In general, the regulation follows federal practice, conforming, for example, to the Revenue Code of 1954 in the revised methods of depreciation accounting.

The deductions which are germane to the question before us are those relative to federal income taxes, Massachusetts income taxes, and income taxes paid to other states and territories, social-security and railroad-retirement contributions, medical expenses, union dues, payments to federal, state, and certain private retirement systems, and finally and most importantly the deductions and exemptions for family and dependents.

The Massachusetts Special Commission on Taxation determined that the total of exemptions and deductions removed about 70 per cent of " business " income from the tax base.[9] The largest category of deductions claimed is, of course, the $2,000 family exemption and the deductions for dependents, which accounted for 80 per cent of the total deductions taken on the Special Commission sample returns. Next in importance is the deduction for federal income taxes paid (17 per cent of the total), followed by much smaller totals for the remaining deductions allowed.

Deductions for Union Dues, Social-Security Taxes and the Like

We may comment on the minor deductions immediately. Deductions for union dues, social-security and railroad-retirement contributions, payments to certain pension systems, and medical expenses do not account for more than 2 per cent of the deductions. They have been incorporated into the law for a variety of reasons which in the main are designed to improve equity, e.g., deductions for union dues are equivalent to the fees paid by professional men.

[9] Commonwealth of Massachusetts, Report of the Special Commission on Taxation, Part II, *The Taxation of Personal Incomes*, House 2279 (Boston, 1951) Table 9.

Massachusetts' Income Taxes

The deduction for Massachusetts income taxes paid has no rational explanation. It is minor in amount and ought to be dispensed with. The tax *credits* allowed for taxes paid to other states, territories, and Canada are equitable and should be continued.

Federal Income Taxes

The deductions for federal income taxes paid are far more important to the tax base. This deduction should be removed. Fifteen of the 31 income-tax states do not allow it, or limit it in some way. It benefits high-income recipients most, and even here its removal would not bear on high-income earners as much as might be imagined because state income taxes are federally deductible. Thus the higher the taxpayer's income the larger the share of the added cost resulting from the elimination which will be shifted to the federal government. The removal of this deduction has been advocated by many groups, including the two most recent special tax commissions.[10] It is also to be noted that this deduction is dependent on federal action. The higher the levels of federal income taxation, the greater are the subtractions from the Massachusetts base and the larger the losses in revenue to the state. Federal tax liability on that portion of income reportable and deductible for Massachusetts' purposes approximates $790,-808,000 which would mean a Massachusetts tax liability of $24,317,000. This estimate is on the high side, it being difficult to account for partnership, fiduciary and other types of income which are reported differently for Massachusetts' purposes. It would seem reasonable to accept an estimate that somewhat over $20 million in additional taxes would be collected if the federal tax deduction were removed.

The deduction has never been available as an offset to income earned from interest, dividends and gains, income which is concentrated in the higher income groups. The higher income groups, of course, would be taxed more if the charge were adopted, but the net additional tax rate falls after a certain point in income is reached. This is illustrated in Table I below, taken from the Soloway study.

The example in the table, based on rates and exemptions in effect in 1958, shows that at the $5,000 income level the net additional tax rate is 0.8 per cent. At $10,000 the difference is 1.6 per cent, but at $100,000 it is 0.8 per cent. The example assumes only business income for the deduction is not available on non-business income. If it were available, the difference observed would be accentuated.

Another way of viewing the effects of the removal of the federal deduction from Massachusetts' statute is to consider the progressivity of the structure after the change. As Soloway has pointed out, the over-all progressivity is reduced because federal rates rise more steeply up to about the $25,000 than they do after that point, while the Massachusetts rates remain constant.[11] In the case of those taxpayers using the standard deductions on the federal level, no change in the tax bill takes place on the federal level.

These considerations lead to no other conclusion than that the elimination of

[10] The 1948 Special Commission on Taxation, *op. cit.*, and the Fiscal Survey Commission, in *Revenue Program for the Commonwealth*, House 2400 (Boston, 1955).

[11] Soloway, *op. cit.*, p. 22.

TABLE I

Effects of Federal and State Deductibility on Effective Rates of Tax, Married Couple With Two Dependents

Net income before personal exemptions	Effective rate of tax				
	Federal only	Massachusetts with no federal deductions	Massachusetts with federal deductions	Combined with no federal deductions	Combined with federal deductions
$ 5,000	10.4%	1.0%	0.7%	11.2%	11.0%
10,000	15.9	2.1	1.6	17.5	17.2
20,000	22.3	2.6	1.9	24.0	23.6
50,000	37.8	2.87	1.7	38.9	38.5
100,000	51.9	2.97	1.4	52.7	52.3
200,000	66.3	3.02	1.0	66.7	66.4

Source: Soloway, *op. cit.*, Table II, p. 21.

the federal deduction in the Massachusetts tax is an equitable and efficient device for increasing state revenues with a minimum of distortions and a minimum additional burden to the taxpayer.

Family Exemption and Dependency Deductions

We may now consider the family exemptions and dependency deductions. These deductions are large in relation to those allowed on the federal income tax. The deduction for dependents is less in Massachusetts ($400) than the federal deduction ($600), but the total of family deductions is greatly increased on the state level by the taxpayer's personal exemption of $2,000 (up to $4,000 on a joint return) plus $500 for the spouse, provided the spouse's income from all sources is less than $2,000. Additional exemptions are allowed blind taxpayers. Annuitants and others whose income would be reduced below certain sums are also allowed deductions, though ordinarily no personal and family exemptions and deductions are allowed against non-business income. Our discussion will be confined to those deductions taken against earned or business income only.

The family exemptions remove the largest portion of the tax base but it may be noted that at higher income and tax levels the federal tax deduction becomes more important to the taxpayer than the family deductions. In terms of deriving new revenue, then, reducing family deductions will impinge most on the middle and lower income groups.

Over 80 per cent of total deductions taken by taxpayers with Massachusetts liabilities under $50 were attributable to the family deductions. It is obvious that any significant widening of the base must involve reduction in the total of personal and dependency deductions. Furthermore, and very important to equity, is the fact that these larger deductions are not available to be taken against unearned income, even if the taxpayer has dependents to support. Various tax commissions have suggested removal of this indefensible inequity including the Special Commission of 1948. The law was changed in 1951 to allow a $2,000 limit on unearned income from the previous $1,000 limit.[12] Even so, taxpayers whose income is only from unearned sources are seriously disadvantaged. It is this provision of the law

[12] St. 1951 c. 800.

that results in its regressive impact at low income levels.[13] Reduction of the personal exemption should make possible a large enough revenue increase to permit all classes of income to benefit by the same level of personal and dependency exemptions.

In comparison to other state income taxes the maximum personal exemptions for single individuals is higher than in 25 of the 31 states having personal-income taxes, and is higher than 21 of them for married couples with only one spouse having income, and is higher than all but two if both spouses have income.[14] On the other hand, the credit for dependents is *lower* than 16 of the states and no state disallows the exemptions against unearned income. Except for the severity of the unearned-income exclusion the Massachusetts' personal exemption and family deductions are in total much more liberal than most other states. Furthermore, most of the states with larger deductions have progressive rates and disallow federal income-tax deductions. In the latter case the differences among states are materially reduced by deductibility at the federal level and the tax " advantages " and " disadvantages " among states begins to vaporize at the high-income levels. The real advantages are at the lower income levels, especially where personal exemptions are high. In this Massachusetts is very liberal.

Certainly revision is called for and it can no longer be argued that the personal exemptions must somehow reflect some minimum standard-of-living concept. What has to be recognized is that the demands of government are so great, the needs so large, and the rich so few, that practically all citizens must make some contribution to the revenue.

We suggest that the same exemption levels be used as in the present federal income tax—$600 per person with extra exemptions for age and blindness as in the Massachusetts' law. There is nothing inherently *right* or *wrong* about this level of exemption. It would bring into the base about 300,000 individuals who now pay no income tax in Massachusetts.

An approximation of the value of this exemption may be obtained based on exemptions claimed and returns filed for federal income taxes. In 1954 all federal returns averaged 2.74 exemptions per return. The difference in value for this level of exemptions between Massachusetts and federal returns is approximately $1,152 ($2,796 minus $1,644) per return. Based on the total number of returns filed for Massachusetts income tax, the tax value of the difference in exemptions was worth about $50.6 million in 1954. On the basis of the estimated taxable federal returns filed in Massachusetts for the same year the tax value was $51.7 million. This computation assumes the deductions would be made available to all, provided it was taken against earned (business) income first.[15]

It is evident that the broadening of the base by lowering exemptions while at the same time extending them so that they may be applied to *all* types of income will increase personal-income-tax revenues greatly and increase equity at the same time. Administrative efficiency will also be improved, as the recent adoption of a withholding provision in Massachusetts would then give the same level

[13] See House 2279, *op. cit.*, Table 18, p. 57.

[14] *Facts and Figures on Government Finance*, 9th Edition, Tax Foundation (New York, 1956) Table 122.

[15] The 3.075 rate on business income was applied.

of basic exemptions as used in the federal witholding. This is the same sort of administrative integration as occurred with the adoption of the federal filing date and identical information returns for the Massachusetts income tax. The broadening of the base and the increased revenues remains, however, as the most important consideration.

IV. REVISION OF THE RATE STRUCTURE

We have assumed that revision of the Massachusetts income tax is necessary to increase revenues above those associated with normal growth of the presently defined base. Can this be done by changing rates only, leaving the base undisturbed? In the process can the impact of the tax remain distributed roughly the same as it is now? Or should rate changes be concentrated on certain types of income? Are progressive rates, levied on all types of income without regard to source, a better method of increasing revenues and improving equity? We should seek answers to these and related questions, but it must be realized there are no definitive answers. Some solutions are " better," e.g., accord more with our notions of equity, simplicity, ease of administration, revenue-raising ability, etc., than others. But the variables that would have to be considered and the knowledge we need but do not have stands between us and the determination of that which is best of all. Indeed, as in so many things, we may have to settle for considerably less than the best solution even if we were so erudite as to know what was best, for political realities are not likely to be humbled before the niceties of economic perfectionism in fiscal affairs.

Progressive vs. Proportional Rates

The committee which drafted the original income-tax legislation in 1915 had reservations as to the practicability of a proportional rate structure in the long-run and it therefore suggested the introduction of legislation which would make possible a progressive rate schedule if and when it was thought wise to bring progressive rates into use. Later studies of the Massachusetts tax system also suggested this possibility, but the Special Commission of 1948 hedged on the matter. Even more numerous have been suggestions to revise the rates on the different classes of income taxed. In all these cases the question of equity was considered and often it was paramount to yield considerations. It would appear, at first glance, that equity could be improved by the imposition of a progressive rate structure. This improvement may be more apparent than real. The base and exemptions of an income tax may be more effective in determining equity than the structure of rates. For example the progressiveness of the federal income tax is greatly exaggerated, given the erosion of the base which has taken place by a host of " technical " amendments to the law.

In the Massachusetts case, the best available data show that because of the differentiation of income by source in the present law that the income tax has an effective progressive impact, but that it is regressive in the low-income range if the income is unearned only, because of the lack of exemptions against this type of income. The taxation of unearned income at higher rates than earned income is the vehicle by which progression is attained. This is also evident from data on partnership and fiduciary returns. Lower income groups are largely exempt from the tax. Nevertheless, there is *not* the deliberate and steady progression one would expect

from a progressive rate structure. The Massachusetts tax is not progressive by *intent.* It cannot be, for progressive taxes are not permissible under the constitution of the Commonwealth.

It would take about four years to bring a progressive income tax into being in the Commonwealth. This long and hard process of constitutional amendment has perhaps been the most important block to the revision of the rate structure. Furthermore, a progressive rate structure, without reducing the present high level of exemptions, could not raise a great deal more in revenue without having a rate structure as high or higher than the typical progressive rates of other state income taxes.

Of twenty-seven states which have rate progression of one sort or another, only six have a top rate of 8 per cent or higher, and the first-step rates are all considerably below the present earned-income rate of 3.075 per cent in Massachusetts.[16] Eight of the income-tax states, excluding Massachusetts, have surtaxes in addition to their progressive rates, but they are low and do not add much to the progression.

In some states the progressive rates are quite without meaning. For example Louisiana has a 2 per cent rate to $10,000 and reaches only 6 per cent at $50,000. Delaware's tax reaches 6 per cent at $100,000. For most incomes the rate is below 3 per cent. New Mexico has a top rate of 4 per cent which is not reached until $100,000 of net income. Indeed only Minnesota, North Dakota, Oregon, Colorado, New York and Kentucky have rates with much rapidity of progression, and of these only New York disallows a deduction for federal income taxes. And given the peculiarities of many of the laws, in some states what appears to be progression is found in actuality to be regression.[17] Utah's rate structure appears mildly progressive but effective rates of tax are actually heavy on low incomes and moderate on high incomes.[18] Indeed, Massachusetts' proportional rates can and do give a higher effective rate of tax on high-income taxpayers than would the substitution of several of the rate structures of the progressive income-tax states. This is due mainly to the lack of deductions and exemptions to be taken against unearned income, coupled with the 7.38 per cent rate on such income. This rate was higher than the highest rates in 22 of the income-tax states in 1958.

It is evident that progressive rates *per se,* do not bring progression *de facto.* It should also be evident that a reduction in exemption levels in Massachusetts will not significantly change the progression now existing in the higher income brackets, so long as the exemption is required to be taken first on whatever *earned* income the taxpayer has. But it will reduce the regressivity of the tax in the lower income brackets when such income is solely from interest, dividends and gains. This is because the vast majority of large incomes are composed of a mixture of types of income in which the unearned portion tends to predominate, and these sources of income are taxed at more than double the rate on

[16] The annuity rate in Massachusetts is not important to the yield of the tax. New Hampshire and Tennessee tax only interest and dividends so that income taxes are limited and the higher rate is not meaningful.

[17] Colorado's tax is regressive at the highest income levels where California's tax is still progressive, for example, even though Colorado's rates are ostensibly higher. See Colorado Legislative Council, *Colorado Tax Structure: The Income Tax,* Report to the Colorado General Assembly (Denver, 1954) p. 27.

[18] *Ibid.,* p. 29.

wages, salaries and business income. If all income were to be taxed at uniform rates then, of course, a progressive rate schedule would *have* to be imposed in order to get any effective progression in the structure. The inequitable feature of the present system is that the progression is uneven and the composition of one's income is more important than the size of that income. It would seem to be more rational and equitable to tax equals equally. If the test of equality is income size *from whatever source derived,* then progressive rates are necessary to attain equity. But if the notion of equity is to tax at a higher rate those who live off of inherited wealth or past savings than those who live off of current earnings, then the present structure (with the exceptions we have previously noted) is equitable.

Another consideration may be noted. There is something to be said for leaving progression up to the federal tax system and *minimizing the regressive* nature of most state systems. This view then subordinates the role of the states in matters pertaining to the attainment of certain social objectives by way of taxation. The states might make a better contribution to these social objectives via spending rather than taxing. That they have an opportunity to do so is evident in the nature of the things to which much of their revenues are devoted, e.g., schools, colleges, hospitals, medical care, welfare and recreation. If state (and local) fiscal authorities were to consider lessening tax regressivity as an end rather than to advocate a positive program for progressivity, it is possible that they would be able to accomplish more than they now are able to with the rather futile attacks on constitutional and institutional limitations to tax freedom. The absolute burdens of state taxes are not yet so large that they can outweigh the progressive effects of the federal structure. And given the tax competition among the states, any given state has a reduced ability to accomplish social objectives with its tax system. In this context then, the opportunity which Massachusetts has with its present income tax is to broaden it significantly and to try to remove from it as many of its discriminatory provisions as possible.

This does not preclude revision involving a progressive structure of rates, but it does advance the proposition that it is better to improve where improvement is possible, rather than to have a whole program stand or fall on progressivity. Furthermore, an imperfectly and hastily conceived " progressive " tax may in the long-run turn out to be, as it has in many states, progressive in name only. And beyond this, any wholesale revision should be accompanied by, if not preceded by, a tightening up of the administration of the tax to assure that the new provisions will be rigidly and equitably enforced, for nothing can so easily sap the vitality of a tax system as laxity in the administration of the law.

In terms of revenue yields, broadening of the base and elimination of certain deductions is a necessary first step. If rates too are to be changed then greatly increased yields can result. We are unable to make any reliable estimates of what a progressive rate schedule, such as New York's, would yield on the current Massachusetts base, for the necessary data cannot be released by the Massachusetts Department of Corporations and Taxation. But if we were to achieve progression second-hand, i.e., by adopting federal definitions of taxable income and taxing at a flat percentage of federal tax liability, then a rate of 9.976 per cent of federal liability would

have been necessary in 1954 to equal the yield of the Massachusetts tax. This is close to the 10 per cent rate which Utah allows taxpayers who use the federal simplified tax table as the basis for computation of their liability under the Utah personal-income tax.[19] In 1954 the effective rate of federal income taxes in Massachusetts on the $4,000 under $5,000 income groups was 8.8 per cent of adjusted gross income. Total federal and Massachusetts' income taxes would then approximate 9.6 per cent of adjusted gross. For the $5,000 under $10,000 group the comparable figures would be 11.0 per cent and 12.1 per cent of adjusted gross.[20] It is not suggested that such a system be applied, though it may have its advantages.

The data suggest that a progressive income tax in Massachusetts would have to have a range of rates roughly from 2 to 10 per cent with the highest rate reached at no higher than $10,000 of adjusted gross to approximate the yields of the present Massachusetts income tax. This would imply a lesser burden on some (low incomes from interest and dividends) and higher burdens on others, mainly in the middle and upper income groups, but with deductibility of state income taxes for federal purposes the net addition to state revenues would be made at a small additional cost to upper income groups. Moreover, such a schedule would bring a more equal treatment of equals.

In the absence of such changes, the present differentiation of income by type would have to prevail.[21] It is unlikely that a rise in unearned income rates would be acceptable without a rise in rates on earned income. Annuity rates seem subject to change least of all, and there is little reason that they should be changed much in any event. Thus the imposition of additional surtaxes or a rise in the rate on wages, salaries and other business income would seem most likely. But the surtax device is confusing and its elimination has been advised by many groups. Unless the system of revenue distribution is radically revised surtax elimination is not possible in any event. It would appear that, in the absence of the base changes suggested, the most likely rate changes will be surtax increases, earmarked for the General Fund, as in the past. Further than this, increases in earned income rates are likely. Pressures in this direction are greatest from upper income groups (aside from agitation for a sales tax) as would be expected. Increases in the earned income rate would reduce the present effective progressivity, however. It should not be accepted by lower income taxpayers unless, at the very least, a *quid pro quo* in the form of removal of the deductibility of federal and state tax liabilities is effected.

This discussion serves to point up at least one vital fact about the Massachusetts income tax and that is changes in it cannot be undertaken on a piecemeal basis, as in the past. The revenue picture is too unhealthy to play about with half-way measures which may serve only to increase the complexity, the administrative difficulties, and the inequities which now exist. It is especially important that measures which are invoked to increase revenues are accompanied by provisions which increase, not decrease, the fairness of the tax. This applies as

[19] For all taxpayers Utah's collections in 1954 were 6.74 per cent of federal liabilities.

[20] *Statistics of Income, 1954*, *op. cit.*, p. 73.

[21] It bears repeating that a levy on "income from whatever source derived" would be necessary for a progressive tax and this *ipso facto* would do away with the classification of income as it now exists.

much to the imposition of a "progressive" rate schedule as anything else.

V. ESTIMATED YIELDS FROM THE SUGGESTED REVISIONS

The changes which have been suggested herein, aside from rate changes, may be summarized in terms of revenue increases as follows:

(1) Revision of federal tax deduction	$ 20–24	million
(2) Revision of state tax deduction	1.5–2.0	million
(3) Revision of personal and family exemptions ...	50.6–51.7	million
(4) Revision of administrative procedures including withholding	20–25	million
(5) Revision of interest, net rents, and Massachusetts trusts exemptions	5–10	million
Approximate increase in yields based on 1954 income	97.1–112.7	million

These estimates are admittedly imperfect and subject to error thereby. This is especially so in items (4) and (5) above. For example, the late Commissioner Long estimated that $20 million could be obtained by administrative revision. Since the tax-department reorganization, many of the elements of that revision have been undertaken, but many have not. Withholding, which is of vital importance in capturing income escaping the collectors and in assuring payment, was instituted this year and its effects on revenues are yet to be determined. In 1957 for example 160,000 individual returns were filed on which tax was due but no payment made. Tax Commissioner Healey estimated that those delinquencies approximated $8 million.[22] But a more likely figure is around $4-5 million.[23]

The figures cited above do not take into account tax evasion, which can be significant. The revisions suggested with respect to interest, rents, and Massachusetts trusts is also subject to error. Much depends on the exact changes which can be achieved under the law and the exemption level to be granted interest payments received. The low figure of $5 million is based on the assumption that only savings and cooperative bank interest would be taxed, and that none of the other suggested changes would be made.

On the basis of 1958 income we may assume that between $120 million and $130 million of additional revenue may be derived from the Massachusetts personal-income tax provided that the revisions suggested above and various administrative improvements are adopted. No changes in rates need accompany this revision. Both yields and equity can be increased and little effect may be anticipated with respect to the competitive relationships with other states. Two major impacts are to be noted. One is that a very large number of taxpayers who now pay little or no income tax will now have to bear more of the burden than previously. The other is that though the higher income groups will pay slightly more, a significant share of the added burden will be shifted to the federal government. And not to be overlooked are the improvements in equity to be obtained.

All of this can be accomplished without recourse to constitutional amend-

[22] *Boston Globe*, July 28, 1958, p. 1.

[23] This is most likely a generous estimate. It was based on an average of $52 owing per return. The mean was $68.02 in 1954, but the *median* was about $25.00 and the median is the sensible figure to use.

ment. Thus the present tax, though seriously in need of revision, is not to be thought of as a law unable to be improved as is often implied by the proponents of a Massachusetts sales tax. The progressivity argument should not preclude intelligent revision now. The possibility of a progressive rate structure, which can improve the tax further, may indeed someday come into being. At that time the rate structure may or may not be arranged to enlarge the revenue. The needs of the moment will determine that.

VI. THE IMPACT OF THE PRESENT AND PROPOSED TAX

It is interesting to observe the impact of the present tax compared to the impact under the proposals which have been suggested. The comparisons which have been made reflect the circumstances of the great majority of taxpayers. No strange and unusual combinations of income have been assumed.

The impact of the present and suggested taxes on a four-person family at various levels of adjusted gross income are given in Table II. Federal liability is given for comparative purposes. The present tax on earned income (which is the only income considered in Table II, being by far the most predominant form of income at the income levels discussed) has no impact on the taxpayer with a wife and two children where adjusted gross is less than approximately $3,550. But the revised tax, which would lower exemptions to $600 per person and remove the deductions for federal and state income taxes, imposes a burden of $16 at 1957 rates on this taxpayer with $3,000 of adjusted gross income. Were 1957 New York rates to be imposed, on the *same base* as in the revised Massachusetts tax, the tax would be $11, a result of the lower rate (2 per cent) being imposed. Both revisions would tax residents heretofore exempt, but the absolute burden would be small. The differences between the two suggested revisions is one of progression, of course. Below $6,000 of income the New York rate system would impose less of a burden, and above $6,000 more of a burden, than the flat rates under the revised Massachusetts tax. The present Massachusetts tax, per $1,000 of increase in income, has an increasing impact to about $8,000 of adjusted gross and then a slower rate of change, due to the deductibility of federal and state income taxes which account for a proportionately larger deduction as incomes increase, hence a proportionately smaller state tax impact. The effective rates of tax, illustrated in Table III reveal more clearly this aspect of the present tax.

The effective rates of the present tax move upward fairly rapidly in the lower-bracket incomes, as do the revised taxes. The revised taxes show higher effective rates in all cases, but the increases in the upper brackets are greater due to the lack of federal deductibility. Of course, for those taxpayers who would be brought under the tax for the first time, the increases are infinitely larger and this is what we must expect of using percentage comparisons in such cases. The important point is that the absolute impact is small and the effective rates at low incomes are hardly burdensome.

The retail-sales tax proposed by Governor Furcolo, and defeated by the legislature in the last session (1958) would have imposed a larger burden.

It is interesting to note where the Massachusetts tax stands in comparison to the income taxes of other states.

Using 1955 rates (which are the same for Massachusetts in 1958) the Iowa Taxation Study Committee computed the tax bill for 29 states, New Hampshire and Tennessee being excluded as they tax only interest and dividends.[24] Fourteen states taxed the $3,000 income groups (same four-person family as in our example above), from a low of $1.60 to a high of $25.52. Massachusetts was not among them, of course. At the $5,000 level Massachusetts ranked eleventh of the 29 states imposing a tax.[25] Assuming no changes in the rates and provisions of the other states, the *revised* Massachusetts tax would have placed Massachusetts fifth and the revised tax with progressive rates would have put Massachusetts in twenty-fourth place. At the $10,000 income level the present tax puts Massachusetts in fifteenth place. The revised tax would place it ninth and the progressive rate tax in fourth place. At the $20,000 income level the present tax would again give Massachusetts a low rank, the revised tax would shift the rank upward and the progressive tax would shift it upward even more. Thus at low-income levels the revised tax would shift Massachusetts toward the upper ranks, and the progressive tax toward the lower, from its present position. But in the higher income groups the process would be reversed. Again we may emphasize, however, that because of federal law, the deductibility of the state income tax would *reduce* the differences among the states for much of the *added* burden would be absorbed by the federal government. This effect is not shown by the final comparison made in the Iowa study.

TABLE II

Tax Liabilities of Four-Person Family Under Present and Proposed Revision Massachusetts Personal Income Tax *

Adjusted gross income	Federal liability	Present Massachusetts liability ¹	Revised Massachusetts liability ²	Revised Massachusetts base with New York rates ³
$ 1,000	none	none	none	none
2,000	none	none	none	none
3,000	$ 58	none	$ 16	$ 11
4,000	236	$ 13	46	35
5,000	416	37	77	65
6,000	600	61	108	104
7,000	780	85	139	140
8,000	976	107	169	185
9,000	1,174	132	199	235
10,000	1,372	156	231	350
20,000	3,800	384	538	1,035

* Earned income only. Married couple, filing jointly, two dependents, 1958 rates. Tax bills rounded to nearest dollar.

¹ Present exemptions and rate on earned income (3.075).

² Present Massachusetts adjusted gross, $600 per person exemption and no deduction for federal or state income tax.

³ Revised base as in (2) above, with New York progressive rates of 2% first $1,000, 3% $1,001–$3,000, 4% $3,001–$5,000, 4% $5,001–$7,000, 6% $7,001–$9,000 and 7% above $9,000.

[24] Iowa Taxation Study Committee, *Iowa's Tax System—A Factual Survey*, Part I. Report to the Governor and General Assembly, State of Iowa (Des Moines, 1956) pp. 54-56.

[25] *Ibid.*, Table 44, p. 55.

But one fact is evident: the present tax on earned income places Massachusetts in the lowest ranks at high-income levels. For example, at a $100,000 earned-income level, the Massachusetts burden is *third lowest* of the 29 states. Wisconsin is first, Vermont second and North Carolina third.[26] The effect of unearned income in the Massachusetts and other state bases would shift the rankings, of course. The position of Massachusetts would depend on the composition of that income and in other states the proportion of short vs. long-term capital gains, etc., would affect the rankings. Comparisons for all types of income would not be helpful for the ranks would shift with every combination. In general, however, the Massachusetts rank would be *high* at low-income levels when unearned income was included and *low* at high-income levels, not only because of the flat rates, but also because of the exclusion of income from rents, etc., which more typically accrue to high income recipients.

[26] *Ibid.*

The effects of selected levels of unearned income on the tax liability of the present tax are shown in Table IV. Various combinations of earned and unearned income are assumed. The uneven impact of the tax is illustrated by the effective rate for those taxpayers having $1,000 of unearned income. It is highest on the lowest income group. With larger levels of unearned income, the effective rate rises even though earned income is also rising, but if the earned income rises while unearned income remains constant, the effective rate will fall, as the comparison of incomes at $12,000 and $13,000 illustrates. If only unearned income accrues to the taxpayer, the rate is highest of all, and it would remain constant (provided it was above the exemption level) no matter the size of the income, for under present law no deduction against this type of income may be taken.

The peculiar impact of the present tax may also be illustrated by comparing the effective rates of tax on the adjusted gross incomes shown in Table III

TABLE III

Tax Liability as Per Cent of Adjusted Gross Income under Present and Revised Massachusetts Income Taxes

Adjusted gross income	Tax liability as a per cent of adjustde gross income			
	Federal	Massachusetts	Revised Massachusetts	Revised Massachusetts with New York rates
$ 1,000	...	...	...	...
2,000	...	...	...	...
3,000	1.90%	...	.53%	.37%
4,000	5.90	.33%	1.15	.87
5,000	8.32	.74	1.54	1.30
6,000	10.00	1.02	1.80	1.73
7,000	11.14	1.21	1.99	2.0
8,000	12.20	1.34	2.11	2.31
9,000	13.04	1.47	2.21	2.61
10,000	13.72	1.56	2.31	3.50
20,000	19.00	1.92	2.69	5.18

Source: Computed from Table II.

with those incomes containing both earned and unearned sources as in Table IV. At the lowest income levels the differences are greatest (for the combinations assumed) and are reduced as income increases. Nevertheless, a taxpayer presently having half of his $20,000 income from interest, dividends, and gains would pay more than double the tax paid by another individual in the same bracket all of whose income was from wages and salaries. But if the tax were revised, this taxpayer would not only pay less than at present but he would be treated no differently than his counterpart. Thus equity is served, and it is not to be lightly dismissed. At low-income levels the percentage reductions would be even greater, the difference in effective rates being much reduced.[27]

Another peculiarity of the present tax, which would be eliminated under both the suggested revisions, is that which results from both spouses working and both receiving the personal exemption of $2,000 and under certain cases still able to take the extra $500 exemption for the spouse. Table V presents the tax liabilities and effective rates of tax for selected income levels of our four-person family with both spouses working.

TABLE IV

EFFECTS OF UNEARNED INCOME ON TAX LIABILITY OF FOUR-PERSON FAMILY AT SELECTED INCOME LEVELS, MASSACHUSETTS PERSONAL INCOME TAX, 1958 RATES *

Adjusted gross income			Tax liability on			Effective rate of tax
Earned	Unearned	Total	Earned	Unearned	Total	
None	$ 1,000	$ 1,000	...	....	....	...
$ 1,000	1,000	2,000	...	$ 74	[a]	...
1,500	1,000	2,500	...	74	[a]	...
2,000	1,000	3,000	...	74	$ 74	2.46%
3,000	1,000	4,000	...	74	74	1.85
4,000	1,000	5,000	$ 13	74	87	1.75
5,000	1,000	6,000	37	74	111	1.85
6,000	2,000	8,000	61	148	209	2.61
7,000	3,000	10,000	85	221	306	3.06
8,000	4,000	12,000	107	295	402	3.35
9,000	4,000	13,000	132	295	427	3.28
10,000	5,000	15,000	156	369	525	3.50
10,000	10,000	20,000	156	738	894	4.47
None	20,000	20,000	...	1,476	1,476	7.38

* Man, wife and two dependents. Wife has no earned income. Earned income rate: 3.075%; Unearned rate: 7.38%.

[a] No tax liability because the tax on unearned income would reduce income below $2,500 (for married couple).

It is evident that the effective rate of tax is much reduced for working couples. At the $7,000 income level, the effective rate for a working couple is about 27 per cent of that of a couple at the same earned-income level with only one spouse earning the income. The revised tax would eliminate this inequity.

VII. TAX ADMINISTRATION

It is only fair to state that the revisions in the tax which have been suggested cannot do what they are designed to do

[27] Some additional computations showing the impact of the Massachusetts tax where both earned and unearned income are included are given in State of Vermont, Vermont Tax Department, *Tax Facts* (revised edition) (Montpelier, 1956) pp. 21-26.

if administration of the tax is weak and enforcement erratic. The major reason the Massachusetts tax has fallen into cynical disrepute has been its thoroughly inadequate enforcement in the past. Indeed, *every* onerous provision of the law could be neglected if the law as a whole could be flouted. The tax had always been pretty much an affair concerning the well-to-do anyway. What did it matter that a war would so change employment and income that thousands more would be brought under the tax? It became common knowledge that its payment could be easily evaded.[28] Making the tax reach many more taxpayers and widening its base for those already taxed demands an attention to its administration not heretofore given, even after the 1953 reorganization of the Department of Corporations and Taxation and the Income Tax Bureau.

Though the administration of the income tax has been vastly improved through the use of modern accounting machinery and mechanization of many operations, the adoption of a short-form with a standard deduction, the improvement in forms, the issuance of regulations and the improvement of taxpayer relations, much has yet to be done if the tax is to become the broadly based major revenue producer of the Massachusetts system in the years ahead.

There remains in its administration significant gaps. There has yet to be a prosecution for fraud for evasion of the tax. There is little statistical erudition practiced in the department. Little or no information on the tax and its collection is published by the Department of Taxation. No annual report has been made since 1949, though it is required by law to be published every year. The statute which prohibits any information on the income tax to be released, except that of the most general kind, should be repealed. Audit surveys should be undertaken and a greater use of federal tax returns made. There should be a continuous sampling of the returns for statistical appraisal of tax and as an aid in its administration, especially in the

TABLE V

IMPACT OF PRESENT MASSACHUSETTS PERSONAL INCOME TAX ON FOUR-PERSON FAMILY WHEN SPOUSE HAS EARNED INCOME, 1958 RATES *

Adjusted gross income of			Tax liability	Effective rate	
Husband	Wife	Total		With spouse working	Without spouse working
$2,000	$2,000	$ 4,000	...	0	.33%
3,000	2,000	5,000	...	0	.74
4,000	2,000	6,000	[a]	0	1.02
5,000	2,000	7,000	$ 23	.33%	1.21
6,000	2,000	8,000	48	.60	1.34
7,000	2,000	9,000	71	.79	1.47
8,000	2,000	10,000	96	.96	1.56
2,500	2,500	5,000	...	0	.74
3,000	3,000	6,000	15	.25	1.02
5,000	5,000	10,000	111	1.11	1.56

* Earned income only, rate of 3.075%.

[a] Tax liability begins at slightly over $6,000.

[28] A later article, to be published in this journal, will detail administrative improvement problems in Massachusetts.

desk audit of returns. The pay and working conditions of the employees in the tax department should be upgraded in order to attract men of exceptional ability, and the political influences on the department should be continued to be lessened, as they appear to be doing at the moment. On no grounds should the department ever again become the catch-all for defeated legislators and second-cousins. There is always the possibility that the former laxity may return. If it does the tax will not yield what it should be able to and recourse to other taxes may be taken. This will only serve to make the Massachusetts tax system appear more imperfect and inequitable.

VIII. A SALES TAX VERSUS INCOME TAX REVISION

Governor Furcolo has proposed a "limited" tax on retail sales, as one possible solution to the need for increased revenue in Massachusetts. It was defeated in the 1958 legislative session and appears unlikely to pass during the 1959 session, the General Court having cut the proposed budget by over $20 million and revenues having increased so that the budget can be balanced. The drive for a balanced budget stemmed largely from the desire to avoid a sales tax and also to deflate an inflated budget. There remains the problem, however, of increasing the revenues available to the cities and towns. Any substantial increase in state aid could only come by additional taxation. A sales tax in Massachusetts, along with the *present* income tax, would increase the regressive impact of the system as a whole, especially when it is evident that the present Massachusetts system already collects 34 per cent of its taxes via selective sales taxes and at least 8 per cent of total taxes in other excises, e.g., public utility and motor-vehicle taxes which are passed to the consumer or borne directly by him. Soloway has indicated this and shown the *total* burden of the present personal-income tax and a 2 per cent sales tax to be slightly progressive but, of course, impinging on income groups previously exempt.[20] The suggested revision of the personal-income tax would not tax those lower income groups and the negligible progressivity of the suggested sales tax could be replaced by a much more deliberate progressivity under the New York-rate structure. Thus if the electorate wants some sort of meaningful progressivity it can hardly look to a limited sales tax as a method of accomplishing this end.

More important perhaps is that the acceptance of a sales tax would effectively prevent any revision of the present personal-income tax except, perhaps, an *increase* in personal and dependency exemptions as a consideration for support of the sales tax by lower income groups. While an increase in exemptions would not be inconsistent from the point of view of the equity of the tax structure as a whole if it contained a sales tax, such a revision would not improve the equity of the income tax itself. More importantly, the glaring inequities and major difficulties now inherent in the tax would most likely remain. To add to the total structure a tax which is in general regressive, as it is most often employed, would only serve to make the Massachusetts tax system more of an irritant than it already is.

Some of the disputants in the sales-tax versus income-tax debate have insisted

[20] Soloway, *op. cit.*, pp. 32-34 and Table VII. The Furcolo proposal is for a tax of 3 per cent.

that the sales tax is *the only* alternative remaining to Massachusetts if it wishes to raise an additional $100 million or more of revenue. It is hoped that the revisions suggested herein have served to dispell that notion. It might also be pointed out that whatever a sales tax can raise in revenue an income tax can also, for it is obvious that, with few exceptions, sales taxes are paid out of current income. Furthermore, and this is not a minor consideration, no new enforcement bureau need be set up to administer the tax. The present income tax can be altered to increase yields with very little additional cost to the state for administration. The new withholding system has been the most recent addition to cost (estimated at $280,000) and this is minor compared to the approximate $2.9 million to $3.05 million cost of administering a sales tax. Very few new position would have to be created. This may be contrasted with the possible addition of 250 or more employees necessary for adequate enforcement of a sales tax.

If the changes suggested are brought into being, the Massachusetts personal-income tax can be the major element in the fiscal system and provide the opportunity for reducing and perhaps eliminating some of the more burdensome and inequitable levies which are now imposed at the state and local level. An improved and viable personal-income tax can help to improve the whole fiscal system, a goal long sought and never reached in the Commonwealth of Massachusetts. It can be a major element in helping to reduce the dependency of the cities and towns on property taxation, a dependency which gives Massachusetts a dubious distinction of having the highest per capita property levies of any state in the nation.

The real choice is between a rational and fair revision of a tax we now have which is yielding much less than it can yield, and a wholly new tax superimposed on an already jerry-built tax structure. Much needs to be done with the Massachusetts fiscal structure, and the best place to begin is with a revision of the personal-income tax.

The major public finance problem of such states as Massachusetts is to improve the use of the tax resources which they already possess, and to do it with a sense of care and caution which many of them hitherto have not exercised. Much of the inherited restrictions of tax systems designed for an earlier day may have to be swept away, and the fiscal and administrative relationships of the existing governmental units will probably have to yield to a more realistic system of aids and burdens than those of the present.

THE UNIQUE ILLINOIS USE TAX

JOHN F. DUE *

WHEN the first sales taxes were introduced in the early thirties, substantial fear was expressed by retail groups that loss of business to out-of-state vendors would occur. It soon became apparent that while this fear was exaggerated, the states were losing some potential revenue from out-of-state purchases, with consequent inequity. As a result, in 1935 Washington and California levied compensating use taxes, which applied to the use within the state of tangible personal property, with exemption of all goods which were purchased subject to the state sales tax. The effect, therefore, was to subject to use tax only those items purchased from out-of-state vendors. To the surprise of many legal observers, the Washington tax was upheld by the United States Supreme Court in the case of *Henneford vs. Silas Mason* (300 U.S. 577, 1937).

In the next few years most states using sales taxes added supplementary use taxes, in some instances labeled " compensating " taxes rather than " use " taxes. Some of the newer sales taxes imposed after 1935 incorporated the use-tax feature in the basic sales-tax law, the same procedure followed by the Canadian provinces. By 1959, every state using a sales tax (excluding Indiana, whose gross income tax differs basically from the usual sales tax) employed a general use tax except Missouri, which applied such a levy only to automobiles.

* The author is Professor of Economics, University of Illinois.

The yield ranges typically from 3 to 10 per cent of the sales-tax yield, but the net contribution to revenue is greater, because of the reduction in the incentive to make out-of-state purchases. The use taxes are by no means wholly effective, since it is not practicable to assess the tax against individuals who buy in another state and bring the article home with them, or who order from stores in other states. However, three important categories are reached by the taxes: (1) automobiles, which cannot be licensed until the tax is paid, (2) purchases through the large mail-order houses, which can be compelled to collect the tax from the customer and remit it, since they do business in the state, and (3) taxable out-of-state purchases by business firms subject to audit for sales tax purposes.

The History of the Illinois Retailers' Occupation and Use Taxes.—The state of Illinois was one of the last three states (together with Arizona and West Virginia) to impose a general use tax, but when it did so, it selected a form which differs basically in structure, if not in effect, from those of the other states, and which materially altered the general nature of the Illinois sales tax itself. The long delay in Illinois and the particular form chosen were products of the taxation provisions of the Illinois constitution and the typical approach to interpretation of them by the state Supreme Court. At first glance the provisions appear to be liberal compared

to those of many states, in which tax structures and even rates are prescribed. But traditionally the Illinois Supreme Court interpreted the provisions narrowly, in such a fashion as to limit severely the taxing powers. The legislature has been confined strictly to the imposition of taxes on the basis of property, occupation, and franchise or privilege, and the first of these is bound so rigidly by the uniformity clause as to be almost unworkable for any tax except the general property levy, and has prevented any satisfactory treatment of intangibles under this tax.

Accordingly, when the sales tax was introduced in 1933,[1] it was imposed strictly as a tax on retailers on the basis of the occupation of selling at retail, and was designated as the Retailers' Occupation Tax rather than as a sales tax. The law provided no commodity exemptions, as such, although a number of items taxable in many states subsequently escaped from the coverage of the tax as a result of court interpretations of the concept of a taxable sale. The retailers' occupation tax itself remains basically the same in 1959 as when first introduced, with a rate of 3 per cent.

As other states introduced use taxes, interest developed in such a levy in Illinois.[2] But the difficulties of framing a use tax, in light of the requirements of uniformity and avoidance of exemptions laid down by the constitution, appeared to be very great; in fact, it was by no means obvious that the act of use of a commodity would be accepted by the courts as a privilege within the taxing powers of the legislature. However, in 1951, the legislature enacted a use-tax act applying to cigarettes as a supplement to the state excise tax on cigarettes. On September 17, 1952 the Supreme Court upheld the act in reversing a decision of the lower courts.[3] In 1955, the legislature enacted (under SB510) a general use tax supplementary to the retailers' occupation tax with the unique structure noted below. The tax became effective August 1, 1955, but was immediately contested in the courts, and on October 26, 1956, the state Supreme Court held it to be invalid because it involved unreasonable classification contrary to the constitutional requirements. The state asked for a rehearing, and in stating its case stressed the argument that the tax was basically designed to protect the retailers' occupation tax rather than to constitute a separate levy. In March 1957 the court reversed itself, and by a 6 to 1 decision upheld the validity of the use tax.[4] The court held: (1) that it was a privilege tax within the scope of the concept of privileges subject to tax under the constitution; and (2) that the classification which it contained (taxation only of purchases from persons selling at retail) was reasonable because the levy was complementary to the retailers' occupation tax, even though it might not be if the tax stood alone. The question of the validity of the tax was also carried to the United States Supreme Court, where the case was dismissed for want of substantial federal question.[5]

The Nature of the Illinois Use Tax.— The use tax is defined as a privilege tax

[1] The tax was first imposed as of April 1, 1933. This act was held invalid because of exemptions, and the tax was reenacted effective July 1, 1933, without exemption.

[2] See L. L. Waters, "Use Taxes," in *Report of the Revenue Laws Commission of the State of Illinois* (Springfield: 1949), chap. XIV.

[3] *Johnson v. Halpin, et al.*, 413 Ill. 257, 1952.

[4] *Turner v. Wright*, 11 Ill. (2nd) 161.

[5] *Turner v. Wright*, 355 US 65, and *Burgess-Norton Manufacturing Co. vs. Lyons*, 355 US 65.

imposed on the privilege of use in Illinois of any kind of tangible personal property purchased at retail, whether bought from a firm within the state or outside. Unlike all of the other use taxes, no exemption is provided for goods purchased subject to the sales (retailers' occupation) tax; to do so would have endangered the constitutionality of the act on the basis of the restrictions on classification (and thus exemption). However, to avoid a double burden, which would completely destroy the intent of the legislation, the act provides that the vendor may retain the use tax collected from the customer to the extent that it does not exceed the amount of the vendor's retail occupation-tax liability. Thus, the retailer pays, as he did before 1955, the retailers' occupation tax on his sales, but instead of shifting this forward, he collects from the customer and retains an equivalent amount of use tax, which compensates him for his own retailers' occupation-tax liability to the state. Thus the effect is much the same as that of the usual use tax from which transactions subject to the sales tax are exempt, but the Illinois consumer, technically, is paying the use tax, not an element of retailers' occupation tax shifted forward to him.

The effect of the change was to alter very basically the relationship of the retailer and the customer so far as the tax is concerned. The retailers' occupation tax was regarded, by law, as a levy on the retailer, as such, and the law contained no provisions whatsoever about forward shifting. The retailer was free to do as he pleased; he could absorb the tax, he could readjust his price to include it, or he could shift it as a separate item. The latter practice was the most common, almost as much so as in the states which required it. But retailers were typically careful not to designate this as tax, but as expense incurred as a result of the retailers' occupation tax. Under the new tax, the retailer is required by law to collect the tax from the customer, and, except in a few instances such as sales through vending machines, to quote the tax separately from the price for the product. Failure to collect the tax from the customer can result in civil and criminal penalties (although so far as is known such penalties have never been applied); failure to quote the item separately from the price results in the amount of the tax item being included in the taxable sales figure. Under the old law the state had carefully refrained from issuing any sort of bracket system for collection, the one commonly employed having been developed by the merchant groups without official sanction. Under the new law the bracket schedule is prescribed by regulation and retailers are required to post it. Retailers are likewise prohibited from advertising or indicating that the use tax will be absorbed or refunded (except when the selling price of the goods is refunded). Thus by one major act the Illinois tax was converted from the most extreme of the forms of sales tax strictly on the retailer to one of the types most obviously and directly on the consumer. The change is, of course, one primarily of form rather than substance, but it does affect the practice of retailers.

The scope of the use tax is the same as that of the retailers' occupation tax, with minor exceptions. Out-of-state purchases, of course, are subject only to the use tax. Tax on these is remitted to the state by those vendors who are registered for use-tax purposes, either on a compulsory basis because they also do business in the state, or voluntarily (in

order to permit payment, and save the purchaser the trouble). When purchases are made from nonregistered out-of-state sellers, the purchaser himself is obligated to file a return and pay tax. Such instances are limited largely to purchases by business firms of taxable goods for their own use, and the purchase of automobiles; the latter cannot be licensed in Illinois until use tax is paid. Technically, a resident of Chicago who buys a loaf of bread in Gary and brings it home is subject to payment, but there is no expectation that such transactions will be taxed. On the other hand, sales to the federal government are subject to retailers' occupation tax (such transactions being constitutionally taxable since the levy is imposed on the vendor), whereas they are not subject to use tax. The vendor can recoup his tax in this case only by an upward readjustment in the price. Any vendor who collects more use tax then he owes in retailers' occupation tax is obligated to pay the additional sum to the state, since he is regarded merely as a tax collecting agent so far as the use tax is concerned. Retailers, however, are not required to keep an exact record of the amounts collected, as they are in the Canadian provinces; so long as they use the prescribed bracket system and quote the tax separately, they are presumed to collect no more use tax than they owe in retailers' occupation tax. With both taxes, amounts collected to cover the tax element are not subject to tax; the retailer may either keep a separate record of these amounts, or he may divide his taxable sales figure by 103 (or 103.5, if subject to a municipal ½ per cent tax). This privilege is lost if the tax is not quoted separately to the customer.

The Municipal Taxes.—When the use tax was imposed, no comparable supplement to the municipal retailers' occupation taxes was provided. Following legislation in 1955 that permitted municipalities to impose a retailers' occupation tax up to ½ per cent without a referendum the municipal tax spread rapidly. As of May 1, 1959, 1051 (out of 1188) cities, towns, and villages had imposed the levy. It is collected for them by the state, and is applied to exactly the same base as the state tax. Since there is no use-tax supplement, purchases from out of state subject to the state use levy are taxed only at the state rate of 3 per cent, even though they are acquired by persons living in a city using a local tax. Furthermore, in these cities, the retailer, while collecting a use tax from the customer with respect to the state levy, is not subject to the same requirement for the municipal levy, and thus treats the municipal retailers' occupation tax in any manner which he wishes. Actually the state has provided a bracket schedule which includes the ½ per cent municipal levy, with the title "Combined ½% Municipal and 3% Illinois Use Tax Collection Schedule," just as if the local tax were a use tax. It might be feasible to avoid this anomalous (if relatively harmless) situation by extending the use tax to the local governments. It is extremely important, however, that local use taxes not apply to goods purchased elsewhere in the state; such a rule seriously complicates administration and can result in multiple taxation.

Trade-in Allowances.—The introduction of the use tax created confusion over the question of the inclusion in the taxable price of the sum represented by a trade-in allowance, a problem of major concern with automobiles. This issue had been troublesome even with the retailers' occupation tax. For many years

the state had permitted retailers to exclude the trade-in allowance element, but subjected the sale of the traded-in item to tax when sold. In 1955, the state Supreme Court held this rule to be invalid, and required collection of the tax on the entire price. As a consequence the legislature immediately amended the act to exclude the trade-in allowance from the measure of the tax. The use-tax act contained no similar provision, but the Department of Revenue applied the same rule. However, in the decision upholding the use tax in 1957, the Supreme Court implied that the full sum, including trade-in allowance, was taxable under the use tax. Accordingly, on August 1, 1957, the Department of Revenue changed its rule, and, over many protests, required collection of the tax on the entire sale price. Eventually the action was contested in the courts, and an injunction was issued preventing the application of tax to the trade-in allowance. In conformity with this injunction, on March 6, 1958, the state again changed its rule, and since that time trade-in allowances have not been subject to tax.

The Possibility of Exclusive Reliance on the Use Tax.—Question may be raised about the need for continued use of the retailers' occupation tax; could not the use tax alone be employed, as was suggested in the Report of the Revenue Laws Commission (1949)? Given the situation in Illinois, there are several reasons why the original tax must be retained. The first is a constitutional question; the Supreme Court, in upholding the tax, clearly indicated that the classification involved (whereby, for example, purchase from a retailer is taxable, but the obtaining of a service from a service establishment is not) was valid only in light of the fact that the use tax was a supplemental or protective measure for the retailers' occupation tax, for which such a classification had been held reasonable. In addition, in three instances revenue would be lost by the change: (1) on sales to the federal government, which cannot be taxed under the use tax, (2) on sales under 14¢, which are subject to the retailers' occupation tax but cannot equitably be subjected to the use tax in the absence of a mill-token system, and (3) on certain sales made for delivery in Illinois, the goods being moved out of the state immediately upon delivery.

The revenue differences are essentially relatively minor, particularly in states which do not in any event tax sales to the federal government. Accordingly, other states might find the sole employment of a use tax entirely feasible, and in some instances subject to fewer constitutional obstacles. In May of 1959, the Michigan legislature became aware of this possibility in considering an increase in the use tax to 4 per cent, the sales tax being retained at 3, because of constitutional barriers to readjustments in the latter. It is very likely that this practice may spread.

INCOME TAXES FOR LESSER DEVELOPED NATIONS?

DAVID E. SHIRLEY *

INCOME taxation in the United States is firmly entrenched. Active, and occasionally fruitful, discussion continues on numerous refinements, but those who question the basic concepts of income taxation are regarded as little more than heretics.[1] The tax stands on the almost unassailable political base of "ability to pay," reinforced by its tremendous yield and the economic advantage of "built-in-flexibility." After forty-five years of usage, it is an old and accepted tax.

In the developing nations of the world, such as Iran and India, income taxation has no such entrenched position even though some form of income tax legislation has existed in many of these nations for years. Today, because of the drive for more rapid development, these nations have their entire fiscal programs under almost continuous scrutiny, and the role of the income tax is actively debated. The purpose of this paper is to state briefly the major issues of this debate concentrating on the points which have unique significance for lesser developed nations. It is hoped that this will help to dispell some of the frustrations of the tax experts who accept overseas assignments, and make those who remain at home aware of the favorable environment in which they operate.

Political Considerations

Although there are wide variations in the political conditions which prevail in the various lesser developed nations, there are three circumstances likely to be found in all. First, there is an extremely wide discrepancy in wealth and income between a relatively small high-income group and the majority of the population whose income borders on subsistence. Second, the high-income group is the focus, or more accurately the essence, of whatever political and economic stability exists. This group, tracing its wealth and position to large land holdings, tends to dominate the social, political, and economic structures of the nation. Finally, there is an ardent desire to be considered a modern, progressive nation with political and economic autonomy.

The conflict is obvious. On the one hand, progressive income taxation is desired simply because it is regarded as one of the symbols of a modern government. This desire is reinforced by a recognition that the wide discrepancy in income and wealth is politically dangerous; the tremendous gap offers ready-made propaganda for anyone who chooses to oppose the existing regime on either economic or political grounds. The existence of a progressive income tax provides counter-

* The author is Chief Advisor, University of Southern California Contract Group, University of Teheran.

[1] Blum and Kalven avoided such recriminations by presenting arguments both for and against progressive taxation in a very meticulous fashion and by leaving any conclusions to the option of the reader. Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953).

propaganda, and is often thought to be essential for political stability. On the other hand, there is a very real question whether or not the nation can afford to disturb the *status quo* of the extremely wealthy who provide such current stability as does exist. Since this same wealthy group is the political leadership, the issue is resolved on the basis of how greatly this group fears its own strength.[2]

Economic Considerations

For most of the lesser developed nations of the world, sheer survival dictates rapid economic growth which in turn calls for the achievement of the maximum rate of investment compatible with stability. At the same time, investment is scheduled not only in physical things, but in people and the returns from this latter type of investment are extremely slow. When will the investment in grammar-school education for all village children result in an increased output for the economy? Without knowing the answer to this and many similar questions, the avowed policy of government is maximum economic growth with the result that these nations which are simultaneously improving their physical and human resources are never far from chronic inflation. A dry year or a fall in the world price of their major export commodity could easily result in the chaos of a run-away inflation. Such precarious economic circumstances demand that tax policy be carefully integrated into the nation's aggregate economic policy.

If inflation is to be avoided, the economy must produce substantial savings. Voluntary savings sufficient to counterbalance a high rate of investment are unlikely for two reasons: the low standard of living of the bulk of the population and a prevailing myopia regarding the future. The needs of the majority of families, by their own standards not those of the Western world, are so great that they will absorb their entire income for years to come. Even for that part of the population which is somewhat above the subsistence level, the marginal propensity to consume is apt to remain at 100 per cent for many years. These people have been educated to the relationship between sanitation and health and now seek the improvements which make proper sanitation possible. A little further up the income scale, people desire secondary education for their children, have an intense desire to become property owners, and to install and pay for domestic electric lights. India made a sincere effort through its Small Savings Campaign to increase the amount of voluntary savings from the middle-income group, but in reviewing this experience Bhargava concluded: "Taxation appears to be the only alternative if inflation is to be avoided."[3]

The second force inhibiting voluntary savings is a cultural factor which was previously referred to as a myopia regarding the future. This is not a philosophy of the "Eat, drink, and be merry for tomorrow we die" type, but rather live for the present which is known and the uncertainty of tomorrow will be taken care of tomorrow. Businessmen are concerned with their cash position and with their liquid assets, but not with their complete balance sheet of both current and fixed assets; it is difficult, and in some cases impossible, to persuade

[2] Unfortunately the solution to such a dilemma has all too often taken the form of income-tax legislation which is obviously impossible to enforce. This provides the needed propaganda without impairing the wealth of the high-income group.

[3] R. N. Bhargava, "Taxation Policy," *Public Finance* No. 4, 1958, p. 326.

production people to spend money for proper maintenance of their equipment because of this same attitude. In light of this philosophy, it is not surprising to find financial institutions, such as savings banks, still in their infancy and not well enough developed to be capable of mobilizing limited savings into the large blocks that industrial development requires. Thus, not only is the amount of voluntary savings likely to be inadequate to counterbalance a program of rapid industrialization in developing nations, but the financial institutions necessary to accumulate the small savings of a vast number of people into useful large sums are lacking. One of the basic objectives of national fiscal policy must be to overcome these two inadequacies. A tax policy that reaches almost the entire population is essential.

The one group from whom substantial voluntary savings can be anticipated is the very wealthy; the question arises as to whether or not a nation striving to industrialize can afford to "soak the rich" with taxes, unless, of course, it is committed to socialized industry.[4] No definite studies are available regarding the effects of a steeply progressive income tax on individual incentives in lesser developed nations, but it is the degree, not the direction, of this force which remains in doubt. Pakistan, which inherited a rather effective income tax from the British via India, was restrained from lowering the rates of this tax for political reasons. Nevertheless, the adverse effects of the tax on the incentives of individuals to invest in housing and industry were certain enough to warrant new tax legislation providing special treatment for income derived from such investments in Pakistan.[5]

Administrative Considerations

Despite the high rates of taxation which makes tax avoidance and evasion so profitable in the Western world, the problems of tax administration there are simple in contrast with those faced by the lesser developed nations. These countries lack "the money economy, high standards of literacy among taxpayers, the prevelance of accounting records honestly and reliably maintained, a large degree of voluntary compliance, and an honest and efficient administration."[6] How do you tax a merchant in the bazaar who is very intelligent as attested by his mere survival in a highly competitive situation, who keeps no financial records since he is illiterate, and who has no moral compunction about the payment of taxes so that voluntary compliance is unknown? Reporting on a study of tax compliance of merchants in the City of Tehran, John O. Reese stated:

> "It is clear from the above figures that the legal requirement of declaration of income is ignored by the majority and that the declarations filed by the minority are so low as to be unacceptable. On the face of them they are false and based upon false books, presented with the intention of defrauding the Government."[7]

[4] As noted by Peter Bauer, all too often the error is made of regarding an increase in capital available for government investment as a net increase in the investment of the nation. More often than not, it represents merely a transfer from private to public hands. Peter T. Bauer, "Political Economy of Non-Development," in James W. Wiggins and Helmut Schoeck, Eds, *Foreign Aid Reexamined*, (Washington: Public Affairs Press, 1958), p. 133.

[5] J. Russell Andrus and Azizali F. Mohammed, *The Economy of Pakistan* (Stanford, Cal., Stanford University Press, 1958) p. 321.

[6] Richard Goode, "Reconstruction of Foreign Tax Systems," *Proceedings of the National Tax Association*, 1951, p. 221.

[7] John O. Reese, *A Program of Legislation for the Improvement of Tax Administration in Iran* (unpublished ICA report, October, 1957).

Enforcement problems of this magnitude are not easily solved even when attacked by a highly skilled, devoted, and fearless staff of enforcement officials empowered to assess severe penalties. Given all the resources and powers which are at the command of government, few, if any, of the lesser developed nations of the world can muster such a staff. The usual situation in these nations is that the official charged with the responsibility of collecting governmental revenues must work with a relatively untrained staff of inadequately paid civil servants who have achieved their present status on a straight seniority basis.[8]

Administrative feasibility must be regarded as a tax criteria of primary importance under such circumstances. Failure to provide effective and uniform enforcement will produce results which may be both undesirable and unforeseen. For example, as noted elsewhere the effective mobilization of capital is vital to industrialization; how would this gathering together of capital be effected by a poorly administered income tax? When the trained personnel to provide strict enforcement of taxes are lacking, accurate financial records are a definite risk. The risk can be minimized in the case of an individual proprietor either by keeping no written records or by keeping two sets of records, one for himself and one for the tax collector. As soon as more than one person is financially involved in an enterprise, the problem of dual records becomes more complex; a good illustration of the complexity involved under the corporate form of enterprise came to the author's attention several months ago. The board of directors of a relatively new corporation met to hear the annual financial report and were pleasantly surprised to hear that the company had made a small profit. The board immediately voted to have a second set of accounting records showing no taxable profit prepared for the tax collector. One member of the board refused to accept the decision of the majority and the falsified financial records were of no value unless the board was assured that no member would reveal the true status of the company's finances. In the end, the board voted to retain the original records and give its small profit to a charitable organization in order to avoid the legal requirement for filing a tax return.

An even more serious administrative consideration is the ability of the lesser developed nations to enforce the income tax with equal effectiveness on industrial and agricultural income. This is a goal not yet achieved in the United States.

> It is commonly agreed that of all groups which the income tax seeks to reach, farmers are the most difficult. Indeed the point is often made that in counties and states that are largely agricultural, the income tax cannot be expected to play much of a role.[9]

However, in the United States a solution is sought principally to insure greater tax equity; in a nation striving for rapid industrialization the economic implications of lax tax enforcement on agricultural incomes are even more serious than the inequities between taxpayers. For centuries the most acceptable form in which to hold wealth has been land, and a tax advantage, *de jure* or *de facto*, will merely perpetuate the

[8] Ferrel Heady, "Personnel Administration in the Middle East," *Public Personnel Review*, January, 1959, pp. 49-55.

[9] Harold M. Groves, "Empirical Studies of Income-Tax Compliance," *National Tax Journal*, December, 1958, p. 297.

tradition, and inhibit, rather than stimulate, investment in other activities.

Conclusions

In the lesser developed nations of the world voluntary savings, both their aggregate amount and their effective use, are unlikely to be adequate to finance the rate of progress to which these nations are dedicated. Forced savings must be forthcoming. They can be achieved through inflation, rationing, direct taxes collected from the majority of business enterprises and the bulk of the working population, or through indirect taxes which discourage consumption. Deliberate inflation is dangerous even in nations in which economic activity is wholly government controlled; in mixed economies, inflation is apt to be suicidal. Both rationing and widespread direct taxation requires a combination of a high degree of voluntary compliance and an extremely efficient and extensive administrative organization; in the lesser developed nations of the world, both are lacking.

Despite these conditions, political considerations indicate the desirability of adopting some form of income taxation. The political objective, however, must be recognized as distinct from a revenue objective. Accordingly, the tax should have a very narrow base within the administrative capacity of the enforcement agency and with appropriate exemptions to encourage private investment which is compatible with the overall development planning. The burden of financing the usual functions of government plus the burden of financing a substantial part of the nation's industrialization must rest on indirect taxes. Undoubtedly, such an allocation would be politically unacceptable in the United States today, but extensive reliance on income taxes or other ability to pay measures is a social and economic luxury which the lesser developed nations of the world cannot yet afford.

COMPENSATORY PROPERTY TAXATION: AN ALTERNATIVE

PAO L. CHENG AND ALFRED L. EDWARDS *

PRIOR to the decade of the 1930's, state and local property-tax revenues comprised over 60 per cent of all taxes collected by all levels of government.[1] In 1957, the comparable figure was 13 per cent. Even though the property tax has declined in relative importance, it still accounted for over $13 billion in revenue in 1957. For the most part, this revenue is of greatest importance to local units of government, which accounted for $12.6 billion of the total and represented 87 per cent of all their tax revenues.[2]

The size of present property-tax collections and the probable increase in their use for added funds to cover increasing expenditures, lends credence to the need for investigating its use as an alternative compensatory device.[3]

* The authors are Associate Professor of Finance at University of Massachusetts, and Assistant Professor of Economics at Michigan State University.

[1] The federal constitutional requirement that direct taxes levied by the federal government be apportioned among the states has largely prevented the use of a national tax on property.

[2] U. S. Bureau of the Census, *Governmental Finances in the United States, 1902 to 1957* (Washington: Government Printing Office, 1959).

[3] Recently, the *Wall Street Journal* (October 31, 1958) p. 5, reported that states are again looking at property tax as a source of financing increased expenditures. "Thirty-eight states are submitting to their electorates a variety of proposals as well as candidates for office. But of this number, proposals in a dozen states alone seek to allow state or local government units to levy heavier taxes on real estate, or to encumber realty with greater bonded debt."

I. *The Problem*

Economists are in agreement that countercyclical fiscal policy properly should be the function of all levels of government. However, they see extreme difficulties with respect to making property taxation sensitive to changes in the business cycle. The following is a typical view:

> Countercycle tax policy can make little or no use of property taxes. Annual assessment and collection of property taxes offer little opportunity for the type of immediate adjustability in payments required to serve countercycle purposes. In addition, the local nature of property tax administration mitigates strongly against the possibility of coordinated national countercycle property tax policy. And finally, the poor correlation of property ownership with personal income suggests relatively little effect upon consumption and investment were it feasible to build countercycle elasticity into the tax.[4]

Conceivably, the property tax could make the necessary adjustments to meet the needs of countercyclical policy by manipulating the base of the tax (assessed values) so that it moves with changing prices. Thus in periods of rising prices and incomes, the assessed value of property would be raised and, if rates remained constant, it would increase tax liabilities of property owners.

[4] Philip E. Taylor, *The Economics of Public Finance* (New York: The Macmillan Company, 1956) p. 312.

Conversely, in periods of falling prices and incomes, assessed values would be reduced. However, this kind of flexibility is rarely found in the administration of the property tax. And compensation could be made through rates in any event. A widely held position states:

> It is characteristic for adjustment in assessed value to be 'sticky,' i.e., to lag considerably behind actual values of various items of property. Among the effects of this inflexibility is that ratios of assessed to actual value will automatically rise during depression years and fall sharply during periods of business prosperity and increases in property value. This, in turn, causes the property tax to bear down with special severity on property owners during periods of depression, when liquid funds for tax payments may be scarce. Such scarcity of liquid funds may greatly increase the rate of property tax delinquency, as was true during the decade 1930-1939, and may undermine the long accepted belief that the property tax has a very high degree of fiscal dependability.[5]

The property-tax rate may be used as a fiscal device to reduce the cyclical swings of the economy by endorsing property-tax delinquency in depression and subsequent over-payment during a boom period. If this plan were to be initiated, one authority suggests:

> The public would be left with more purchasing power when general demand was short; government spending would be maintained by deficits financed by inflationary borrowing. During the boom, opposite conditions would prevail. The crucial difficulty, of course, is that local governments need revenue badly during a depression and depend overwhelmingly upon the property tax. Barring fundamental changes in our entire economic and political organization, fluctuations in property tax collections cannot be encouraged as a stabilizer of the general economy.[6]

Of course, it may be argued that during a depression the revenue badly needed by local governments could be secured by borrowing. However, many state constitutions contain a prohibition against borrowing in excess of some specified figure. The limit to the amount of debt that can be incurred by local units is usually expressed in terms of some fixed percentage of the assessed valuation of property for tax purposes. Borrowing on favorable terms, therefore, is difficult, if not impossible, during depression years.

It can be seen then, that the manipulation of the property-tax rate and particularly the tax base, is not feasible. It presents little chance for flexibility and adjustability to the ups and downs of the business cycle. It is apparent that any scheme to make the property tax sensitive to the needs of countercyclical policy must avoid those kinds of adjustments. Add to this the often conservative and budget-balancing attitudes of local-government finance, the proposal we suggest below becomes an attractive device or alternative within the limits of what property taxation can contribute in battling the cycle.

II. *The Proposal*

An advantage of our proposal is that it will not be necessary to change the current property-tax structure and administration of state and local governments. It is proposed, during recessions or depressions, that the unemployed home owner be granted the right to pay property taxes with personal notes to the

[5] O. H. Brownlee, *Economics of Public Finance*, Second Edition (New York: Prentice-Hall, Inc., 1956) pp. 342-343.

[6] William J. Shultz and C. Lowell Harriss, *American Public Finance*, Sixth Edition (New York: Prentice-Hall, Inc., 1957) pp. 477-478.

government. With the cooperation of the federal government, the local government may be allowed to discount these notes with the federal government. The alternative would be for the federal government to insure or guarantee the notes so that the local government may discount them with private financial institutions. Or, the taxpayer may directly discount his insured note with private financial institutions and pay cash to the local government. It may be stipulated that only those home owners who are unemployed (or who can prove that they are unemployed) or those who are drawing unemployment benefits may be eligible for this privilege.

When prosperity returns and the unemployed are called back to work, the federal government could ask the employers to withhold (equivalent to the withholding of personal-income taxes) a part of the employee's pay, in addition to the ordinary personal income tax withheld so as to make the home owner pay back the tax debt on an installment basis. How much should be the amount withheld per week or per month? Assuming the home owner has one year of tax liability, the federal government may exercise discretion in establishing a withholding rate in the light of the current inflationary tendency. The larger the current income, the more the worker's pay will be withheld to pay his tax debt. The amount withheld will be equal to the worker's pay times the withholding rate. This is consistent with the compensatory aim of the federal government and the principle of the taxpayer's ability to pay taxes.

There may be questions as to the method of handling business property taxes and the property taxes paid by retired people or the self-employed. Different criteria of eligibility may be established for these cases. However, it is not unreasonable to assume that business firms are usually more able to finance tax payments in bad years through financial institutions, than the salary and the wage earner. To the extent that some business, especially small businesses, may have gone bankrupt due to cyclical contractions or run into the red for the same reasons, eligibility may be granted on that basis.[7] With respect to the retired people, we may safely assume that their income and ability to pay taxes are not cyclically conditioned in any case. Thus, no problem of eligibility would arise.

We believe this proposal would increase the "spendable financial resources" of the unemployed property owner and his consumption would not need to contract as much. Under present property-tax regulation, a home owner who is unemployed must meet his payments. The taxpayer can secure funds to meet these tax payments by either borrowing from private sources (i.e., financial institutions or from consumers), reduce his assets, including liquid assets; or pay them through foreclosure due to tax delinquency on the taxed property in question. Under our plan, they are offered an additional source of finance.

Whether our proposal is likely to be 100 per cent effective or not is an empirical question. However, it seems reasonable to assume that the unemployed would view a property-tax debt with indefinite maturity as more attractive than a reduction of his liquid assets from payment of the tax, or an increase of

[7] The Small Business Administration might play a role by guaranteeing notes used by businesses to pay property taxes. These notes may then be discounted at private financial institutions. With the creation of the Small Business Investment Companies in the near future (see *Business Week*, October 11, 1958), these notes will have an additional outlet.

debt to financial or other institutions. Besides, he is likely to have a lower interest burden because of the guarantee by the federal government.

If, as we believe, the proposal is theoretically justifiable, there are still the administrative problems that must be analyzed. It is recognized that some problems will become pronounced only after the proposal has become operational, nevertheless, we would like to describe some of the administrative features regarding eligibility, collection, defaults, etc.

It seems plausible that eligibility for the loan privilege would be discontinued during a period of high employment. However, some unemployment would exist in such a period. And, since individuals who happen to be unemployed during prosperity do not pay income taxes, by parallel reasoning it would be inconsistent not to continue eligibility to unemployed property owners throughout the cycle. In other words, our scheme should be fully built in and automatic and not be subject to switching on and off by proclamation.

The re-employed should be required to report to his employer the extent of his tax debt upon returning to work, presumably at the same time he reports the number of exemptions for income-tax purposes. A "standard withholding rate" may be applied to withhold an extra amount of his wages, say 1/50th of his tax debt per week. The Treasury would distribute the proceeds to the creditor institutions holding the taxpayer's note. It may be assumed that a set of identical records are kept by both the Treasury and the creditors.

If the taxpayer should again be unemployed before he clears his debt, he may continue to be eligible for more credit. Though the unpaid balance would increase as he returns to work once again, the "standard withholding rate" would be applied to the larger balance and still could clear it in no more than, say, 50 weeks. On the other hand, a ceiling on the total tax debt permissible could be set, such as 1, 2, or 3 times the current yearly property tax of the taxpayer in question. Eligibility automatically ends when the ceiling is reached.

In the event legislation permits the tax loan to be a lien on the property, a taxpayer should not be permitted to transfer the title of his property without first paying off his tax debt. "Default" occurs when the debtor has permanently left the labor force and has failed to settle his account with his private means for some time. The bank, or any creditor, may move to exercise the right granted under the "federal guarantee," while the Treasury proceeds to institute action against the debtor, either as a general creditor or as a holder of a tax lien on the property.

III. *Conclusions and Implications*

In order to give an unbiased appraisal of our proposal, one must view it in the light of what is meant by compensatory fiscal policy. Mainly a fiscal policy is compensatory when governmental receipts are made to rise or fall with the cycle and governmental expenditures go against it. Given a tax structure, the rise and fall of tax revenues depend on the rise and fall of the tax base and the effective tax rate. For example, a progressive income tax will rise or fall more cyclically than a consumption or sales tax, not only because of the former's more cyclical tax base, but also its progressive rate structure.[8] Unfortunately,

[8] Consumption tax, of course, could be made more cycle-sensitive by making it progressive. See Morton, W. A., "Progressive Consumption Tax," *National Tax Journal*, IV (1951), and also Cheng, P. L., "A

a property tax has no such cyclical built-in features. On the contrary, as previously mentioned, even if its tax base should contract cyclically during recessions, its tax rate would likely rise to compensate it. The paper has assumed that to formulate a technically "ideal" counter-cyclical property-tax scheme by directly manipulating its base or rate is to face almost certain political and administrative defeat. Even if it were made technically "ideal," there would still remain the problem of financing the consequent deficit. Would extensive constitutional change be necessary in order for bonds to be floated, or would the principle of local self-government suffer if direct federal aid were to be sought? However, our scheme bypasses all these difficulties. It nevertheless produces the same effects as any compensatory tax schemes, namely, the redistribution of tax burden from recession to prosperity and the reallocation of consumer expenditures from prosperity to recession. By strict definition, one may not wish to call our scheme a compensatory tax policy, but it says, in effect, that during recessions, the unemployed property taxpayers pay no taxes and let the banks pay it for them, while the federal government endorses the loan and expects to collect it by withholding (which is tantamount to taxing) their income when they are reemployed. Its analogy with the compensatory function of the current federal income tax is almost complete. Thus, during recessions, for example, the unemployed income taxpayers pay no income taxes, and, indeed the banks pay it for them (if, we assume, for the sake of simplicity that the bonds issued by the government are sold to the banks in order to finance the deficit caused by the deficient income tax collection) as the federal government expects to repay the loan or redeem the bonds when the taxpayers are reemployed by collecting and withholding more income tax than it needs to balance its budget on a cyclical basis. In either case, under our assumptions, the financing is done through the banks: one is the government-guaranteed private debt, thus relieving the local governments from the formidable task of deficit financing; and the other is the straight-forward public debt. The net effect on the taxpayers is that they are neither better nor worse off under either method, since the compensatory debts thus created, private or public, are eventually supposed to be paid off by the reemployed.

Directly related to these observations and comparisons above are two important points where the objections to our scheme are most likely to arise. One is the problem of its effectiveness and the other is its extension. Let us discuss them in this order.

1) Let us, first, assess the compensatory effectiveness of our scheme in the light of the current state of property taxation. When unemployed, at the present time, taxpayers can secure funds to meet tax payments by either borrowing from private sources (i.e., from financial institutions or from consumers); reduce their assets, including liquid assets or through foreclosure due to tax delinquency on the taxed property in question or otherwise. Under our scheme, however, they are offered an additional source of finance. Two criteria may be examined to determine its effectiveness: (a) How attractive is the new source of finance? and (b) How severe is the recession?

Note on Progressive Consumption Taxation," *Journal of Finance*, Sept., 1953.

(a) Is a " tax loan " with non-commitant maturity more attractive than incurring private indebtedness or reducing assets? The question is an empirical one, though, a priori, it seems reasonable to assert that an unemployed would welcome and utilize such a standing privilege. Thus, the more attractive the privilege, the greater its effectiveness as a fiscal weapon.

(b) Does a mild recession reduce the effectiveness of our scheme? Yes, it does, because mild recessions can presumably produce only an insignificant number of homeowners seeking property tax relief. It follows, therefore, that the existing system of property taxation poses only a small problem of instability for the economy and that our scheme would not be able to contribute too much to stability during mild recessions. We may counter this argument, however, by pointing out whether a mild recession does not reduce the relative effectiveness of fiscal weapons of any kind. For example, if there were some other compensatory property tax schemes being proposed and appraised, would not they also face the same kind of criticism? To belittle our scheme alone on the ground of its inefficacy during mild recessions is to raise a common point inherent in all compensatory fiscal devices.

Let us compare, second, the compensatory effectiveness of our scheme with that of another hypothetical one which is supposed to function very much like the current federal income tax in that (1) the local governments engage in deficit-financing, and, as a result, (2) the property taxpayers incur no "tax-debt." Assuming that all the unemployed property taxpayers choose to be covered by our scheme, the countercyclical effectiveness of both schemes would be equal, because in either case the taxpayers must eventually pay the same amount of tax over a complete cycle. However, there is a qualification. Under our scheme, a taxpayer is given an "undated" tax bill reminding him of the "tax-debt." Under the other scheme, the private "tax-debt" is replaced by the public debt. Consequently, an illusion is created that he has avoided paying the tax. This illusion may favorably affect his propensity to consume.

2) The second point our proposal might encounter is its extension. For it may be argued that our scheme could conceivably go beyond the property owners and be extended to cover government guaranteed loans for all consumers' tax bills, installment debts, mortgage payments, and consumer expenditures in general. Apparently, this argument could be further extended to suggest a grand plan that the unemployed be allowed to borrow as much as his future income could support, while the government acts as the guarantor and the collector of the loan! This argument apparently confuses the adaptability of an idea such as contained in our proposal with its specific applicability in the area of local governmental finance. The idea of our scheme is not a new one: it has been used in areas where government has become an insurer and a guarantor of private obligations. But its application in fiscal policy is an original approach. The contribution of this paper is to apply the idea specifically to combat the cyclical impotence of local governments and their fiscal inability of deficit financing. That is to say, if we do want an additional fiscal weapon in an area so cyclically recalcitrant, we think we have proposed a scheme which seems to us sound and reasonable.

IS MUNICIPAL FINANCE FISCALLY PERVERSE?

MORTON S. BARATZ AND HELEN T. FARR *

I

IN THE interest of economic stability it is obviously desirable that the revenue and spending practices of municipal governments be consistent and integrated with those of the federal government. It is generally believed, however, that local finance is fiscally perverse, i.e., intensifies rather than dampens both upward and downward movements in general business activity. Or, as it has been stated in a leading textbook:

> . . . one of the major obstacles to effective fiscal policy is the perverse action of . . . local governments, which tend to carry on policies exactly opposite from that [sic] necessary for successful economic stabilization. In depressions they cut expenditures, lay off workers, and raise taxes, while in inflationary periods they increase their expenditures, borrow for building construction, etc.[1]

Broadly speaking, there are three factors that underlie this phenomenon. First, municipal tax systems are characterized by a low elasticity with respect to income. That is, because the bulk of the revenue of local governments is obtained from real-property taxes and imposts of a similar character, changes in the tax yields of municipalities are less than proportionate to changes in private income.[2] Second, municipal expenditures—other than those for relief purposes—tend to vary directly instead of inversely with aggregate spending. Since local governments lack the power to create money and are confronted with a finite tax base, they must trim their expenditures to the wind of their tax receipts. When the latter diminish, so must the former. Finally, the amount of municipal debt varies directly with the level of general business activity. Legal, market, and socio-political factors inhibit the growth of local indebtedness when tax revenues are falling, encourage its growth when revenues are rising.[3]

A model describing the interactions among municipal revenues, expenditures,

* The authors are, respectively, Associate Professor of Economics, Bryn Mawr College, and member of the Marketing Research Department, Bankers Trust Company, New York City. We acknowledge gratefully the criticisms and suggestions of Holland Hunter.

[1] J. F. Due, *Government Finance: An Economic Analysis*, Rev. Ed. (Homewood, Ill.: Richard D. Irwin, 1959), p. 554. Comment in a similar vein may be found in P. E. Taylor, *The Economics of Public Finance*, Rev. Ed. (New York: Macmillan, 1953) p. 130; and P. A. Samuelson, *Economics: An Introductory Analysis*, 4th Ed. (New York: McGraw-Hill, 1958) pp. 137-8.

[2] H. M. Groves and C. H. Kahn, "The Stability of State and Local Tax Yields," *American Economic Review*, XLII (March 1952) pp. 87-102.

[3] M. Newcomer, "State and Local Financing in Relation to Economic Fluctuations," *National Tax Journal*, VII (June 1954) pp. 99-106. See also H. S. Perloff, "Fiscal Policy at the State and Local Levels," in S. E. Harris (ed.), *Postwar Economic Problems* (New York: McGraw-Hill, 1943) p. 223 *et seq.*; A. H. Hansen and H. S. Perloff, *State and Local Finance in the National Economy* (New York: McGraw-Hill, 1944) pp. 52-69; and G. W. Mitchell, O. F. Litterer, and E. D. Domar, "State and Local Finance," in R. A. Musgrave *et al.*, *Public Finance and Full Employment*, Postwar Economic Studies No. 3 (Washington: Board of Governors of the Federal Reserve System, 1945) pp. 105-19.

and borrowing during a major business cycle has never been constructed. Perhaps this omission is because such a model is almost self-evident. Nevertheless, it may be helpful to write it out as follows. In the prosperity phase municipal tax receipts rise, partly because the local tax base broadens, partly because changes are made in both the level and structure of tax rates.[4] Concurrently, the volume of local expenditures rises, reflecting attempts by local governing bodies to satisfy both deferred and newly-created citizen demands for public facilities and services. For a time, the enlarged volume of spending can be financed from current tax receipts. But sooner or later, the former will begin to outrun the latter and the municipality will be faced with budgetary deficits.

As a result of the rise in general business activity, the total assessed valuation of real property will have risen along with local tax revenues. As a consequence, the localities' capacity to incur and service a greater amount of indebtedness will have increased materially. Such is the strength of the "old" fiscal orthodoxy (i.e., annually-balanced budgets) that in some municipalities there will be little further growth in governmental spending. But in many, probably most, localities the community's distaste for unbalanced budgets will weaken relative to its desire for a higher level of collective investment and consumption. Increasing resort will thus be had to deficit financing—a course which can do naught but intensify the rise in money national income.

In periods of depression, conversely, local revenues diminish, albeit more slowly and proportionately less than the fall in private income. Moreover, the assessed valuation of property tends to decline. In the face of these developments, both the community's willingness and its fiscal and legal capacity to borrow on capital account will be lessened materially. Every effort will now be bent towards achieving at least a balanced budget, at most a budgetary surplus, even if this necessitates sharp increases in tax rates or the imposition of new levies.[5] Thus, as aggregate income falls, so also does the net contribution to it of municipal governments.

With this image of the factors affecting local finance and of municipal fiscal policy during *prolonged* booms and depressions, we have no quarrel. The reasoning is plausible and, as will be shown below, empirically verifiable. On grounds both of logic and the available data, however, we question seriously whether local finance is fiscally perverse during fluctuations of *moderate* length and severity. Under such conditions, we submit, it tends to compensate rather than aggravate. That is the burden of the discussion which follows.

[4] The expansion of the tax base stems largely from (a) increments to total assessed valuation of realty arising from new construction and from upward adjustments in prevailing assessments, and (b) increased income from licenses, fees, and sales and income taxes (in communities which impose such levies). Among the less obvious methods of changing the tax-rate structure is the practice of raising (or lowering) the ratio of assessed valuation to current market value of real property.

[5] The tax policy of the City of New York during the 'thirties may well be the classic example of local fiscal perversity. Following is a list of "emergency" revenue measures adopted by the City in 1933 and 1934: 1/20 of 1 per cent tax on the gross receipts of business firms (1933), 1/10 of 1 per cent tax on the gross income of financial businesses (1933), 1 per cent tax on the gross income of utility companies (1933), 3 per cent tax on the gross income of companies maintaining underground conduits (1933), and 2 per cent tax on retail sales, except food and drugs (1934). *The New York Times*, 1 July 1959, p. 24: 1-3.

II

Requisite to a thorough test of the propositions above is a collection of data which would permit a comparison, month-by-month or even quarter-by-quarter, between local expenditures and revenues on one hand, and gross national product on the other. With materials of that kind it would be possible to determine not only *how* local finance has responded to fluctuations in the system as a whole, but also *when*. Monthly or even quarterly figures would, in other words, permit a reasonably precise estimate both of the extent and the timing of fiscal reactions at the local level.

Contrasted against these desiderata, the available evidence is rather inadequate. For one thing, comprehensive monthly data on local revenues and expenditures are simply not to be had. Neither, for another, are there any quarterly figures which relate solely to municipal finance; there are, however, materials of that kind for state and local governments combined.[6] And while the annual data on local finance are both detailed and extensive, they are in certain respects not closely comparable: the collecting agency has " considerably refined and modified " its methods of classifying data over the decades, and has by necessity changed periodically the size of its statistical sample.[7]

While the published statistics have their limitations, they can be made to yield information of direct relevance to the problem at hand. To utilize the quarterly data on state-local finance combined, for example, the realistic assumption need only be made that state and municipal governments follow very similar fiscal policies.[8] And because the Census has altered its concepts and methods only infrequently, comparisons may legitimately be made of year-to-year variations in its data on municipal income and outgo over fairly long periods of time. In short, the empirical evidence that is available sheds some light, however fitful, on the issue at bar. For that reason it will be used here. It must be stressed, however, that the conclusions derived from it must be regarded as highly tentative.

III

Recorded in Table I are yearly aggregates of revenues and expenditures of municipal governments between 1920 and 1958 (excluding the war and immediate postwar period, 1941-1947). The figures reveal, among other things, that over the course of a major business cycle local finance is indeed fiscally

[6] U. S. Department of Commerce, *U. S. National Income and Output* (Washington: U. S. Government Printing Office, 1958) p. 120 *et seq.* These data cover the period, 1946-57. Comparable figures for 1958 and early 1959 may be found in the *Survey of Current Business*, May 1959, pp. 6-7.

[7] U. S. Bureau of the Census, *Historical Statistics on State and Local Government Finances, 1902-1953* (Washington: U. S. Government Printing Office, 1955). This publication contains both a discussion of statistical concepts and methods, and compilations of local revenues, expenditures, and borrowing for selected years since 1902. Figures for all years except 1914 and 1920 may be found in the Census publications, *Financial Statistics of Cities*, and its successor, *Compendium of City Government Finances*, published annually.

[8] Evidence attesting to the validity of the assumption may be found in Newcomer, Hansen and Perloff, and Mitchell, Litterer and Domar, cited in n. 3 above. See also E. C. Brown, " Fiscal Policy in the 'Thirties: A Reappraisal," *American Economic Review*, XLVI (December 1956). A dissenting view is expressed in A. M. Sharp, " The Counter-Cyclical Fiscal Role of State Governments During the 'Thirties," *National Tax Journal*, XI (June 1958) pp. 138-45. But consult the critique of Sharp's analysis by J. A. Maxwell, " Countercyclical Role of State and Local Governments," *National Tax Journal*, XI (December 1958) pp. 371-6.

TABLE I

ANNUAL EXPENDITURES AND REVENUES OF LOCAL GOVERNMENTS; AND GROSS NATIONAL PRODUCT, 1920–1940 AND 1948–1958 [a]

(Billions of dollars)

Year	Gross nat. product [b]		Local expenditures [c]		Local revenues [d]		
	Amount	Incr. or decr. (–)	Amount	Incr. or decr. (–)	Amount	Incr. or decr. (–)	Surplus or deficit (–)
1920	$ 84.9	...	$ 3.3	..	$3.1	..	– $0.2
1921	67.4	– $17.5	3.7	$ 0.4	3.2	$0.1	– 0.5
1922	68.4	1.0	4.1	0.4	4.0	0.8	– 0.1
1923	80.4	12.0	4.6	0.5	4.2	0.2	– 0.4
1924	80.8	0.4	5.1	0.5	4.5	0.3	– 0.6
1925	84.9	4.1	5.6	0.5	4.8	0.3	– 0.8
1926	91.1	6.2	6.2	0.6	5.1	0.3	– 0.9
1927	89.6	– 1.5	6.6	0.4	5.4	0.3	– 1.2
1928	91.3	1.7	7.0	0.4	5.7	0.3	– 1.3
1929	104.4	13.1	7.3	0.3	5.8	0.1	– 1.5
1930	91.1	– 13.3	7.2	– 0.1	6.2	0.4	– 1.0
1931	76.3	– 14.8	7.1	– 0.1	6.3	0.1	– 0.8
1932	58.5	– 17.8	6.4	– 0.7	6.0	– 0.3	– 0.4
1933	56.0	1.5	5.2	– 1.2	5.7	– 0.3	0.5
1934	65.0	9.0	5.4	0.2	5.7	0.0	0.3
1935	72.5	7.5	5.5	0.1	5.8	0.1	0.3
1936	82.7	10.2	5.5	0.0	5.7	– 0.1	0.2
1937	90.8	8.1	5.6	0.1	5.6	– 0.1	0.0
1938	85.2	– 5.6	5.6	0.0	5.5	– 0.1	– 0.1
1939	91.1	5.9	5.6	0.0	5.4	– 0.1	– 0.2
1940	100.6	9.5	5.6	0.0	5.4	0.0	– 0.2
1948	259.4	...	3.76	...	3.05	...	– 0.71
1949	258.1	– 1.3	4.23	0.47	3.21	0.16	– 1.02
1950	284.6	26.5	6.01	1.78	4.72	1.51	– 1.29
1951	329.0	44.4	6.23	0.22	5.08	0.36	– 1.15
1952	347.0	18.0	6.72	0.49	5.55	0.47	– 1.17
1953	365.4	18.4	7.28	0.56	6.02	0.47	– 1.26
1954	363.1	– 2.3	7.86	0.58	6.39	0.37	– 1.47
1955	397.5	34.4	8.36	0.50	6.79	0.40	– 1.57
1956	419.2	21.7	8.89	0.53	7.29	0.50	– 1.60
1957	440.3	21.1	9.93	1.04	7.76	0.47	– 2.17
1958	437.7	– 2.6	11.00[e]	1.07[e]	8.16[e]	0.40[e]	– 2.84[e]

[a] Data on local finance for 1920–1940 were adapted from G. W. Mitchell, O. F. Litterer, and E. D. Domar, "State and Local Finance," *op. cit.*, p. 115. Figures for 1948 and 1949 are totals for 397 municipalities with a population of 25,000 or more in 1940; those for 1950–58 are totals for 481 municipalities with a population of 25,000 or more in 1950. All data for 1948–58 are from U. S. Bureau of the Census, *Compendium of City Government Finances* (Washington: U. S. Government Printing Office, 1949–1959).

[b] Figures for 1920–28 were taken from S. Kuznets, *National Product Since 1869* (New York: National Bureau of Economic Research, 1946) p. 51. Those for 1929–58 are from U. S. Department of Commerce, *U. S. National Income and Output*, p. 119. Because of differences in national-income accounting concepts, the Kuznets data are not directly comparable to those of the Department of Commerce.

[c] Excluding debt repayments.

[d] Excluding transfers received from other governmental jurisdictions, but including receipts from sales by governmental enterprises.

[e] Estimated.

perverse. Throughout the prosperous 1920's, and again during the secular boom of the 1940's and 1950's, there were yearly increases in municipal expenditures, increases which almost without exception exceeded the annual in-

crement to local revenues. As a result, local governments as a group consistently operated at a deficit, the size of which tended to grow ever larger. Thus, the excess of outgo over income rose from $200 million in 1920 to $1,500 million in 1929, and from $700 million in 1948 to $2,800 million in 1958. During the depressed 1930's, on the other hand, local spending diminished materially, relative to revenues. The budgetary deficit of all municipalities combined fell steadily from $1,000 million in 1930 to but $400 million in 1932; by 1933 local governments were taking in more than they were spending.

While the figures in Table I thus fortify the orthodox view that municipal finance intensifies both major booms and major busts, they also reveal that local spending and revenues are themselves subject to long upward and downward swings. Relative to gross national product, therefore, they move up slowly and move down slowly. Thus, in the 'twenties and again in the 'forties and 'fifties, local finance intensified the secular rise in GNP, but assisted in the stabilization of each of the short recessions that marred the two booms. And during the 'thirties, municipal finance aggravated the secular decline in GNP, but assisted in the stabilization both of a short upturn and a short downturn.

To particularize, between 1920 and 1929 there were two recessions, 1920-21 and 1927-28.[9] Similarly, between 1947 and 1959 there were three downward readjustments, 1948-49, 1953-54, and 1957-58. Just before, during and just after each of these five reversals local expenditures rose absolutely and relative to local revenues, resulting in an increase in the total municipal deficit. In every case, therefore, as GNP dipped in the midst of a long-run boom, the "net contribution" of local finance, already positive, became larger, i.e., the size of the combined municipal deficit grew.[10]

Specifically, these were the year-to-year changes in municipal spending and the combined deficit of all localities before and during each recession since the close of World War I: 1920 to 1921, spending up $400 million, deficit up $300 million; 1926 to 1927, spending up $400 million, deficit up $100 million; 1937 to 1938, no change in spending, deficit up $100 million; 1948 to 1949, spending up $500 million, deficit up $30 million; 1953 to 1954, spending up $600 million, deficit up $200 million; and 1957 to 1958, spending up $1,000 million, deficit up $700 million.

Just as striking were the movements of the fiscal variables during the Great Depression. During these years, without a doubt, there were powerful elements of perversity in the behavior of municipal finance, as is particularly attested by the sharply reduced rate of spending and the measurable rise in revenues between 1930 and 1932.[11] As against this, however, it must be noted

[9] The fluctuation of 1923-24 was so slight that it scarcely deserves mention here. It will be noted, however, that in that case, too, local finance was compensatory.

[10] As is well known, certain kinds of expenditure and revenue have a greater impact on the level of aggregate income than others. This means that the budgetary deficit or surplus is only a crude measure of the net governmental contribution. The latter term is used here merely to simplify the exposition.

[11] The growth in local revenues stemmed in part from increases in the rates of existing taxes and the levying of new imposts, especially on retail sales and gross business income. To the extent that municipal governments tapped idle funds in the hands of the public, then used the proceeds to finance public spending, the increase in local tax receipts was not a depressant but a stimulant to the economy.

TABLE II

STATE AND LOCAL GOVERNMENT EXPENDITURES AND RECEIPTS, SEASONALLY ADJUSTED QUARTERLY TOTALS AT ANNUAL RATES, 1947–1959

(Billions of dollars)

Year and quarter	Receipts[a]		Expenditures		Surplus or deficit (–)
	Amount	Incr. or decr. (–)	Amount	Incr. or decr. (–)	
1947					
I	$13.1	..	$13.2	..	– $0.1
II	13.5	0.4	13.9	0.7	– 0.4
III	14.0	0.5	14.9	1.0	– 0.9
IV	14.5	0.5	15.6	0.7	– 1.1
1948					
I	15.2	0.7	16.7	1.1	– 1.5
II	15.8	0.6	17.2	0.5	– 1.4
III	16.0	0.2	18.0	0.8	– 2.0
IV	16.3	0.3	18.2	0.2	– 1.9
1949					
I	16.9	0.6	19.1	0.9	– 2.2
II	17.1	0.2	19.7	0.6	– 2.6
III	17.5	0.4	20.6	0.9	– 3.1
IV	17.8	0.3	21.2	0.6	– 3.4
1950					
I	18.2	0.4	22.1	0.9	– 3.9
II	18.8	0.6	22.6	0.5	– 3.8
III	19.6	0.8	22.4	– 0.2	– 2.8
IV	19.7	0.1	22.7	0.3	– 3.0
1951					
I	20.7	1.0	23.1	0.4	– 2.4
II	20.7	0.0	23.7	0.6	– 3.0
III	21.1	0.4	24.0	0.3	– 2.9
IV	21.5	0.4	24.2	0.2	– 2.7
1952					
I	22.1	0.6	24.7	0.5	– 2.6
II	22.7	0.6	25.4	0.7	– 2.7
III	23.0	0.3	25.5	0.1	– 2.5
IV	23.6	0.6	26.0	0.5	– 2.4
1953					
I	24.1	0.5	26.7	0.7	– 2.6
II	24.4	0.3	26.7	0.0	– 2.3
III	24.8	0.4	27.3	0.6	– 2.5
IV	25.0	0.2	27.9	0.6	– 2.9
1954					
I	25.6	0.6	28.8	0.9	– 3.2
II	26.2	0.6	29.6	0.8	– 3.4
III	26.4	0.2	30.6	1.0	– 4.2
IV	26.8	0.4	31.1	0.5	– 4.3
1955					
I	27.6	0.8	32.0	0.9	– 4.4
II	28.2	0.6	32.6	0.6	– 4.4
III	29.1	0.9	32.9	0.3	– 3.8
IV	29.9	0.8	33.4	0.5	– 3.5
1956					
I	30.9	1.0	34.3	0.9	– 3.4
II	31.4	0.5	35.1	0.8	– 3.7
III	32.0	0.6	35.7	0.6	– 3.7
IV	32.5	0.5	36.8	1.1	– 4.3

TABLE II (*Continued*)

Year and quarter	Receipts [a]		Expenditures		Surplus or deficit (-)
	Amount	Incr. or decr. (-)	Amount	Incr. or decr. (-)	
1957					
I	33.2	0.7	38.5	1.7	- 5.3
II	33.6	0.4	38.7	0.2	- 5.1
III	34.0	0.4	38.9	0.2	- 4.9
IV	34.1	0.1	40.6	1.7	- 6.5
1958					
I	34.5	0.4	41.6	1.0	- 7.1
II	35.0	0.5	42.1	0.5	- 7.1
III	35.8	0.8	42.8	0.7	- 7.0
IV	36.9	1.1	44.0	1.2	- 7.1
1959					
I	37.7 [b]	0.8	45.5	1.5	- 7.8 [b]

[a] Excluding federal grants-in-aid.
[b] Estimated.
Source: U. S. Department of Commerce, *U. S. National Income and Output*, pp. 166–7; and *Survey of Current Business*, May 1959, p. 7.

that (a) the level of municipal expenditures in 1930 and 1931 was only moderately less than in 1929, the bulk—nearly 80 per cent—of the reduction coming in 1932; (b) through 1932 the " net contribution " of municipalities, though decreasing in size, remained positive; and (c) throughout the upswing of 1933-36 local income exceeded local outgo. Both in the early stages of the depression and during the " New-Deal recovery," in other words, local finance tended to be compensatory.

A similar, though less clearly-defined, image emerges from the data on state and local finance between 1947 and 1959 (Table II). Throughout this period the expenditures of states and municipalities grew at a more rapid rate than their revenues, the ensuing deficits intensifying the secular boom that characterized the period. It is apparent, at the same time, that the continuing excess of outgo over income softened the impact of each of the postwar recessions, perhaps contributed importantly to the fact that none of the economic reversals were of undue length or severity.

IV

A simple but usable model can be constructed to explain this behavior. When in the midst of a secular boom GNP begins to fall, there will be a tendency for municipal tax revenues to diminish too. For reasons noted earlier, however, the drop in municipal income will be small, relative to the change in private income. In many communities, moreover, the full extent of the reduction in tax receipts may not become known for weeks or even months after the recession's start.[12]

Faced with no immediate prospect of a substantial decline in their revenues,

[12] Under certain conditions tax receipts may remain unchanged. In localities almost totally dependent upon real-property taxes the annual tax collection date may follow the recession's onset by several months. By the time tax bills fall due the recovery may be well under way. Tax delinquencies would tend to remain at normal levels, thus obviating the need for changes either in the level or structure of tax rates.

and inclined to be confident that the downturn will be brief and of mild severity, local governing bodies will not be under pressure to trim capital outlays. On the contrary, they will prefer to proceed with projects for which appropriations have already been made. They will carry to completion any public works currently under construction. And officials in localities the public debt of which has not yet reached the legally-allowable maximum, may even authorize an increase in capital expenditures. This is especially likely if in the wake of the recession there has been a marked drop in long-term rates of interest and a corresponding increase in the availability of loanable funds; under such conditions, capital improvements previously shelved may now seem feasible.

Similarly, there will be little or no reduction in general operating expenditures, i.e., outlays on education, protective services, sanitation, and so on. For one reason, municipal officers and their electorates retreat as grudgingly from high levels of collective consumption as they do from high levels of personal consumption. For another, even if cuts are made in certain categories of operating expense, they may well be offset in whole or part by enlarged welfare outlays, especially relief payments to the unemployed.

With total expenditures running in excess of revenues, local governments will for some period add more to the nation's income stream than they withdraw from it, thereby dampening the downswing in general business. The question is: for how long after the upper turning point has been passed will they continue to do so? Hypothetically, this would seem to depend for the most part on the climate of expectations among municipal officials. Should they regard the current recession as just another in a series of inevitable but brief interruptions in a secular boom (as, in retrospect, were the readjustments of 1948-49 and 1953-54), they may countenance a rising deficit for several months, perhaps even longer. If, on the other hand, the downturn mars a fitful recovery from a major depression (as did, for example, the recession of 1937-38), the municipal governors may react with rather prompt perversity.

While these seem to be plausible hypotheses, such is the state of the empirical evidence that they cannot be subjected to a meaningful test. It seems certain, in any case, that the period during which municipal finance is truly compensatory will be comparatively brief.[13] Equally clear is it, however, that during that period it may contribute materially to the success of national stabilization policy.

V

To summarize briefly, the evidence at hand confirms the orthodox view that municipal finance is fiscally perverse with respect to *major* swings in economic activity—it intensifies both protracted inflations and depressions. But because

[13] Following is a simplified model explaining why local finance helps to stabilize short booms occurring during a major depression. As GNP moves up, tax receipts tend to rise, though less than proportionately to the change in private income. Because of this and because the accumulated experience of the recent past has purged local officials of all traces of optimism, few communities will be inclined promptly to increase expenditures out of purely local resources. The rise in local revenues will result in a smaller deficit or a larger surplus. In other words, until the municipal decision-makers consequently become convinced that a major recovery is under way, they will cling to fiscal policies which are perverse with respect to the secular downswing, but compensatory with respect to the minor upswing.

local finance moves up and down more slowly than GNP, it assists in the stabilization of minor recessions occurring during secular booms, and in the stabilization of minor upturns occurring during periods of long-run depression. These compensatory effects, it seems clear, are not the result of conscious planning on the part of municipal officials. They must be attributed for the most part to lags in the responses of local policymakers to changes in the system as a whole, lags which are the direct outgrowth of imperfect information and uncertainty as to the future. In this important respect, the stabilizing impact of local finance is accidental or unintended.

Given the economic and institutional factors noted earlier, it is doubtful whether the fiscal actions of municipalities can be made fully compatible to those that promote national economic stability. But municipal governments can and do have a role to play: elements of built-in flexibility can be introduced into their revenue systems; certain categories of local expenditure can be made more variable with respect to business fluctuations; municipal debt limits can be made more flexible.[14] The total impact of these adjustments may at most be modest. But even if they do no more than lengthen the period during which local finance has a compensatory influence, they will help moderate the major swings in the economy. For this reason alone they are worth serious consideration.

[14] Detailed proposals along these lines may be found in each of the works cited above, p. 2, n. 3.

NTA NOTES

From the President

The most important matter for consideration by all members of NTA at this time is whether they will be in attendance at the 52nd Annual Conference of the Association which is scheduled to be held in the Rice Hotel, Houston, Texas, October 25-29, 1959.

There is more than ordinary meaning in the fact that our Association serves the interest of all. For this reason every aspect of taxation and public finance (regardless of how objectionable to some) has been substantially improved through the years of our Association's existence, at all levels of government, not only in the United States but around the world.

Everyone attending the conference will have an opportunity to participate in the discussions following each scheduled session, time permitting. Each member of NTA has received a preliminary program of the conference. I know you will concur with me as to the importance and timeliness of the chosen subjects as well as the selection of excellent speakers. Chairman Al Burger and the members of his Program Committee have worked diligently, long and hard, to make this program a reality.

Being certain that all of the objectives of the Purpose Clause of our Articles of Incorporation, with respect to the program, have been fully complied with, we may now look to the social activities planned for your pleasure which, to many, are of no lesser importance. Chairman Phil Robira and the members of his Local Arrangements Committee have, in the true Texas tradition, provided "big things." So interesting and outstanding are the events that you cannot afford to miss them, even if you can't afford to attend the conference. No details! See you in Houston!

Your Executive Committee met in Buffalo, N. Y., July 9, 1959, during the annual meeting of the National Association of Tax Administrators. All matters coming before the meeting were disposed of in an expedient and satisfactory manner. The financial condition of the Association was found to be good, as usual. Also, as usual, it was found that we need more members. This is a matter in which we all have a mutual interest.

PLEASE GIVE THE CARD IN THE BACK OF THIS JOURNAL TO A PROSPECTIVE MEMBER OR USE THE CARD TO SEND THE NAME OF A PROSPECTIVE MEMBER TO OUR VICE PRESIDENT, WALTER W. WALSH, CHAIRMAN OF NTA MEMBERSHIP COMMITTEE, 122 EAST 42ND STREET, NEW YORK 17, N. Y.

The activities of the study committees of our Association are at an all-time high. Chairman Fred Cox and the members of the Committee on Interstate Allocation of Business Income have had many hectic days in keeping abreast of happenings in Washington. Chairman Roger Freeman and the members of the Committee on Financing Public Education are making fine progress. Chairman Aaron Neeld and members of the newly created committee on the Cost of Taxpayer Compliance and Administration are busy laying the foundation for this worthwhile project. All chairmen of all committees will be given more time at the Houston conference to make extensive reports of every committee's activities.

I have asked our Executive Director, Walter Kress, to reprint, if possible, the information covering the procedure followed at each annual meeting which was so excellently compiled by our Past President Ken Allen and printed in the September 1958 issue of our Journal. Such information is of utmost importance to all persons attending the conference.

Stanley J. Bowers
President

* * * * *

From the Executive Director

Every member should read carefully the foregoing notes from President Bowers as he has emphasized at least three things important to all:

1. The Houston Conference.
2. The all-time high activity of NTA Study Committees.
3. Membership—urging the use of card attached at the end of these notes.

The following reprint from the September 1958 JOURNAL is inserted at the request of President Bowers:

EXCERPTS FROM "NTA NOTES FROM THE PRESIDENT"
by H. Kenneth Allen—September 1958 Journal

"Annual conferences are sponsored by the National Tax Association, but they are not a convention of the Association. Sessions of the conference are separate and distinct from the business sessions of the Association. A business session of the Association is held each year immediately preceding the first conference session, and the annual meeting of the Association is held, as required by the by-laws, on the day preceding the last day of the annual conference.

"Almost every year some misunderstanding has arisen at the conference with reference to the adoption of resolutions on questions of taxation or public finance. . . . The Association is not a propagandist organization. To safeguard this policy, the voting power in each conference upon any question involving an expression of the opinion of the conference on a question of taxation or public finance is limited. Two groups are eligible to vote on such questions.

The first group includes members of the Association in attendance; and the other group includes delegates in attendance appointed by governors or other chief executives. In the membership group, each member in attendance has one vote, and each state in the delegate group has one vote.

" Unless there is substantial unanimity of each group on the subject in question, it cannot be considered as expressive of the opinion of the conference. Substantial unanimity requires a four-fifths favorable vote of each group entitled to vote, provided that at least thirty-three and one-third per cent of the members of the Association registered at the conference, and, in the case of the group representing states, at least fifty per cent of such states represented at the conference, shall have voted. Voting by proxy is not permitted. It should be remembered that the purpose of these rigid requirements is to preserve the true purpose of the conference, that is, to disseminate facts and information relative to public finance and taxation, and to provide a forum for an open and free discussion of taxation and public finance questions."

Houston Conference

The management of the Rice Hotel, Houston, Texas, where the 52nd Annual Conference on Taxation, sponsored by the National Tax Association, will be held October 25-29, inclusive, reports that reservations are coming in fast and in quantity.

Members and others planning to attend are urged to make their reservations as soon as possible. Such action will not only assure the securing of the desired accommodations but also help Chairman Phil Robira and his Local Arrangements Committee in their endeavors to have the envelopes and badges available at the Registration Desk which will be ready for business Sunday, October 25, at 2:00 PM on the Mezzanine floor.

Wherever possible those planning to attend the Conference should arrive in time for the Opening Reception and Buffet Supper to be held from 6:00 PM to 8:30 PM, on October 25, at the Rice Hotel.

The members and those delegates whose appointments have been made are in receipt of copies of the Preliminary Program. Many favorable comments on the work of Program Chairman Al Burger and his Committee have been received.

Full details on the technical and business features will appear on the Final Program which will be available upon registration. Entertainment features will be included. A letter is being sent to every member by Mrs. Robira, the Ladies Chairman, regarding the program for the ladies and the appropriate clothing for the Houston climate in late October. A real surprise in the entertainment program is in store.

President Bowers' Reappointment

The Ohio State Journal, sent to me in early August by C. Emory Glander, announced the reappointment of Stanley J. Bowers as Tax Commissioner of

Ohio for a four-year term. In editorial comment, this Columbus newspaper said, in part, "He has done an excellent job in administering Ohio's complex tax laws. He deserved reappointment and it is gratifying to see his record and his worth recognized. The people of Ohio are the beneficiaries."

Lawson Purdy

Lawson Purdy, the first Vice President of National Tax Association and one of its founders, died at his home in Port Washington, New York on August 31, 1959.

I had talked with Mrs. Purdy just a few days before on the telephone after she had written concerning his serious condition. Secretary Mattersdorf informed me immediately when the end came. Appropriate messages were sent by President Bowers and myself.

Mr. Purdy, who would have been 96 years old on September 13, was elected an Honorary Member of the Association at the Golden Anniversary Conference in Columbus in 1957.

Report of NTA Committee on Equalization

The Executive Committee thought so well of the report of the NTA Study Committee on State Equalization of Local Property Tax Assessments that it authorized an order for a large quantity of reprints of the report in covers. This judgment of the value of this particular report (which was made at the Philadelphia Conference and which can be found in the 1958 Proceedings at pages 316-365) has been justified by the number of orders already received.

Anyone desiring copies of this report should send the order to our headquarters office, National Tax Association, 905 Payne-Shoemaker Building, Harrisburg, Pennsylvania. They are available in any quantity at 25¢ per copy.

ACT QUICKLY AS THE SUPPLY IS RAPIDLY DIMINISHING.

Membership

Again President Bowers has requested interest and action by the members in securing or recommending new members. The card is attached in this issue of the JOURNAL immediately following these Notes. The application side clearly shows the fees and quarterly starting dates as well as the different categories of membership.

PLEASE USE THIS CARD.

WALTER J. KRESS
Executive Director

NATIONAL TAX ASSOCIATION

Organized 1907—Incorporated 1930

OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: memberships for students in recognized institutions of higher learning, $10; memberships for government agencies, schools, and persons receiving more than one-half of their income from employment by such agencies or schools, $10; memberships for other individuals and unincorporated entities, $25; corporate memberships, $100; persons wishing to contribute more liberally to the support of the Association, $100 to $1000.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is $5.00 per year, single numbers, $1.50. The prices of the PROCEEDINGS vary; that of the 1958 volume is $12.00.

Applications for membership, orders for publications, and general inquiries should be addressed to Walter J. Kress, Executive Director, National Tax Association, 905 Payne-Shoemaker Building, Harrisburg, Pennsylvania.
